

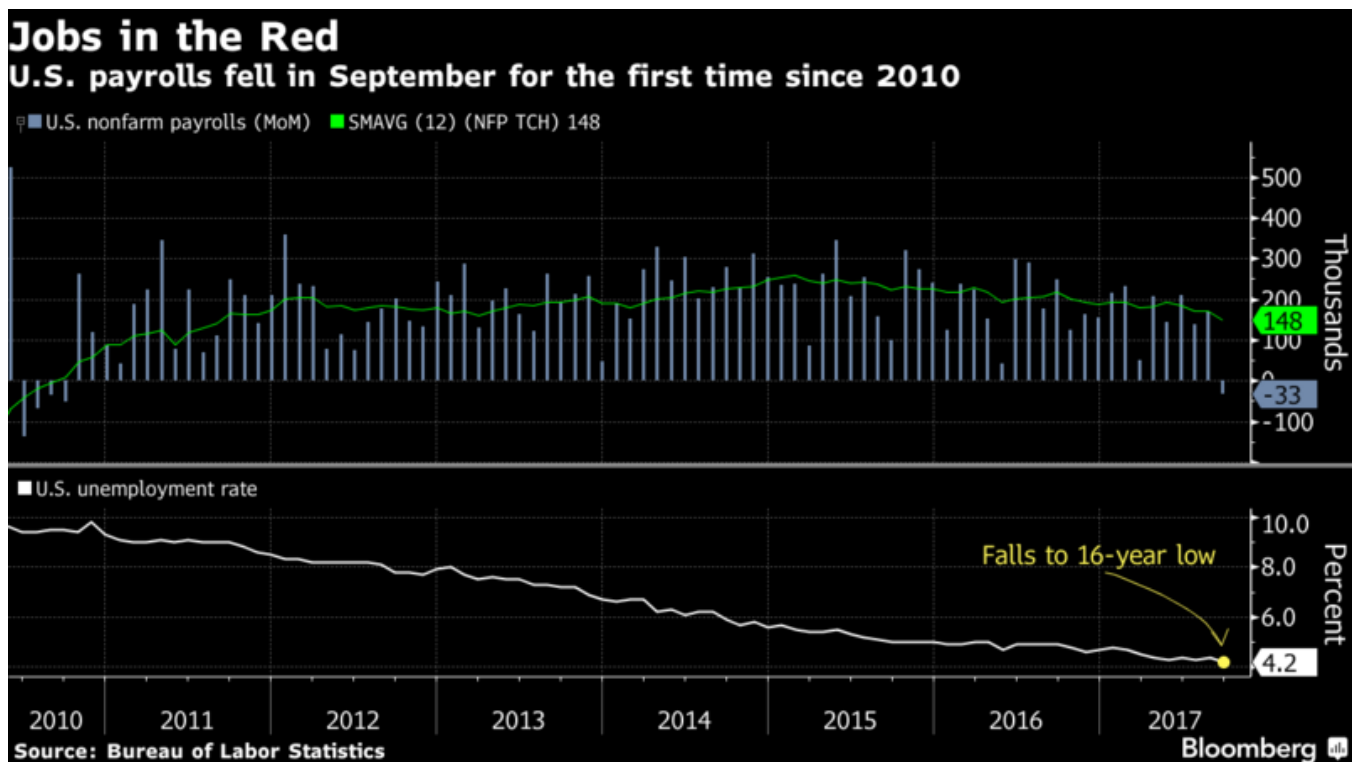


October 6th, 2017

The Top-Down

The September [employment report](#) was released by the Labor Department this morning and nonfarm payrolls fell 33,000. The two previous months were revised down 51,000. The unemployment rate was 4.2%. Futures were down slightly on the news and the 10-year Treasury traded up to 2.4%.

Nonfarm Payrolls and U.S. Unemployment Rate



Source: Bloomberg

Stillwater View: Due to storm related distortions, this number was considered too noisy to provide a dependable read on current employment.

The short list for the Fed chair is narrowing and a decision could be delivered within the next few weeks. *Fortune* profiled the [names under consideration](#), as well as their respective pros and cons. Jeff Gundlach threw out a non-consensus pick in [Neel Kashkari](#). We listen to Jeff because he runs \$120 billion and picked Trump when nobody else would.

Former front runner Gary Cohn may have cost himself the job with his [public rebuke](#) of the President after his Charlottesville remarks. And later his [private rebuke](#) over seared scallops at the [Frisky Oyster](#) on Long Island.

Stillwater View: With Cohn out it's Kevin Warsh's to lose. Full disclosure, if Stillwater's Fed choice is as good as it's sports picks, Kevin has no chance. And Frisky Oyster? Seriously? Name notwithstanding, the [menu](#) looks quite refined. The 45 oz. Wagyu Tomahawk Ribeye at \$160 is strictly for closers.

Another week, another strong rally for the markets. The S&P is now up 5.6% in the last 30 trading sessions. For some that would be a respectable year, as the average *annualized* return over the last 90 years is 9.8%.

Peter “Einstein” Tuchman on the Floor of the NYSE



J.P. Morgan detailed their thoughts on [how this might end](#). The firm highlights several specific market developments that have transpired to potentially create "severe liquidity disruptions". These include the decrease in the number of active value managers and the increase in strategies that buy and sell on autopilot.

President Reagan's Director of the Office of Management and Budget, David Stockman, continues to make the rounds with his call that we are headed for a [market correction](#) of between 40% and 70%. He

first counseled clients to get defensive on November 3rd of last year. Following his prediction, the S&P 500 has risen 22%.

"This is a bubble created by the Fed," he said again this week. "We're heading for higher yields. We are heading for a huge reset of pricing in the risk markets that's been based on ultra-cheap yields that the central banks of the world created that are now going to go away because they're telling you that they're done." He referred to any outlier event coming from the White House as an "Orange Swan".

"Orange Swan"

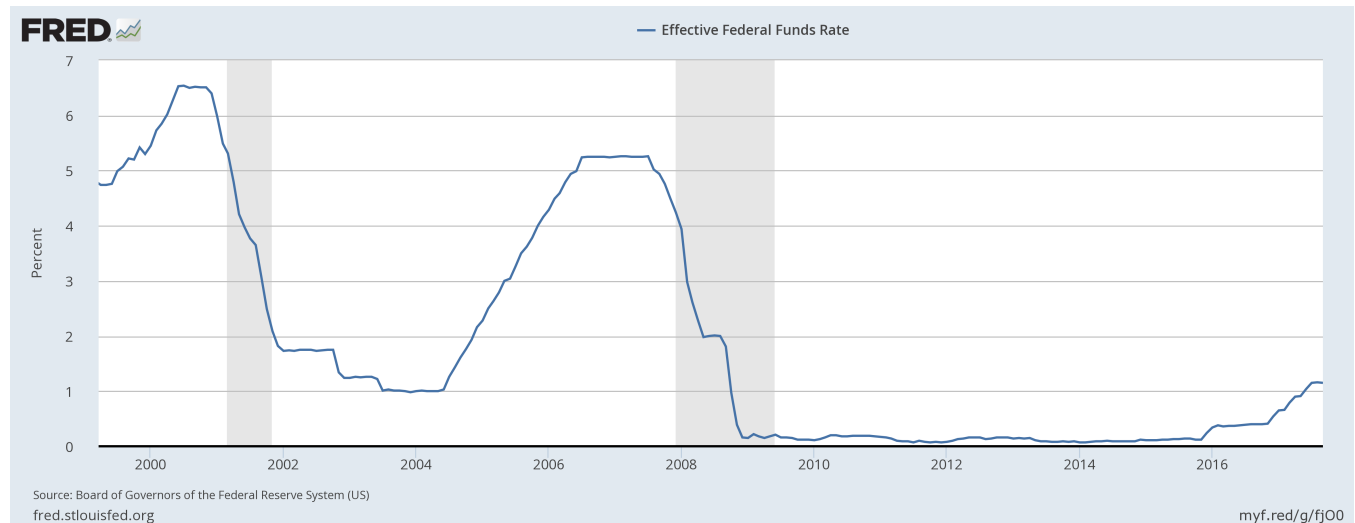


Stillwater view: Stockman has been beating the drum on his "major correction" trade for 11 months. If he indeed has money behind the call, it hasn't been much fun. While this doesn't make him wrong, he certainly is early. David still gets style points for "Orange Swan" though.

One of David Stockman's most relevant calls is that the Fed hasn't adequately re-racked interest rates for the next downturn. The Federal Reserve aggressively dropped rates following the 2001-2002 recession to spur growth. Once the economy was on stable footing they went on a 425 basis point tightening campaign.

Four years later, when the Great Recession hit, the Fed had dry powder to use. Stockman's criticism is that today's 100 basis points of dry powder is nothing compared to the 500 and 600 the Fed had in its back pocket during the two previous episodes.

Effective Federal Funds Rate



Source: The Federal Reserve

The Bottom-Up

Nordstrom traded down this week on news that the family was having a [difficult time](#) finding a partner to bankroll a private acquisition of the company. The reality is that private equity has a spotted record of success in turning troubled retailers around. *Exhibit A:* [Toys 'R' Us](#). *Exhibit B:* [Neiman Marcus](#) and *Exhibit C:* [J. Crew](#). *Money* magazine provides their list of 22 retailers [at serious risk of bankruptcy](#).

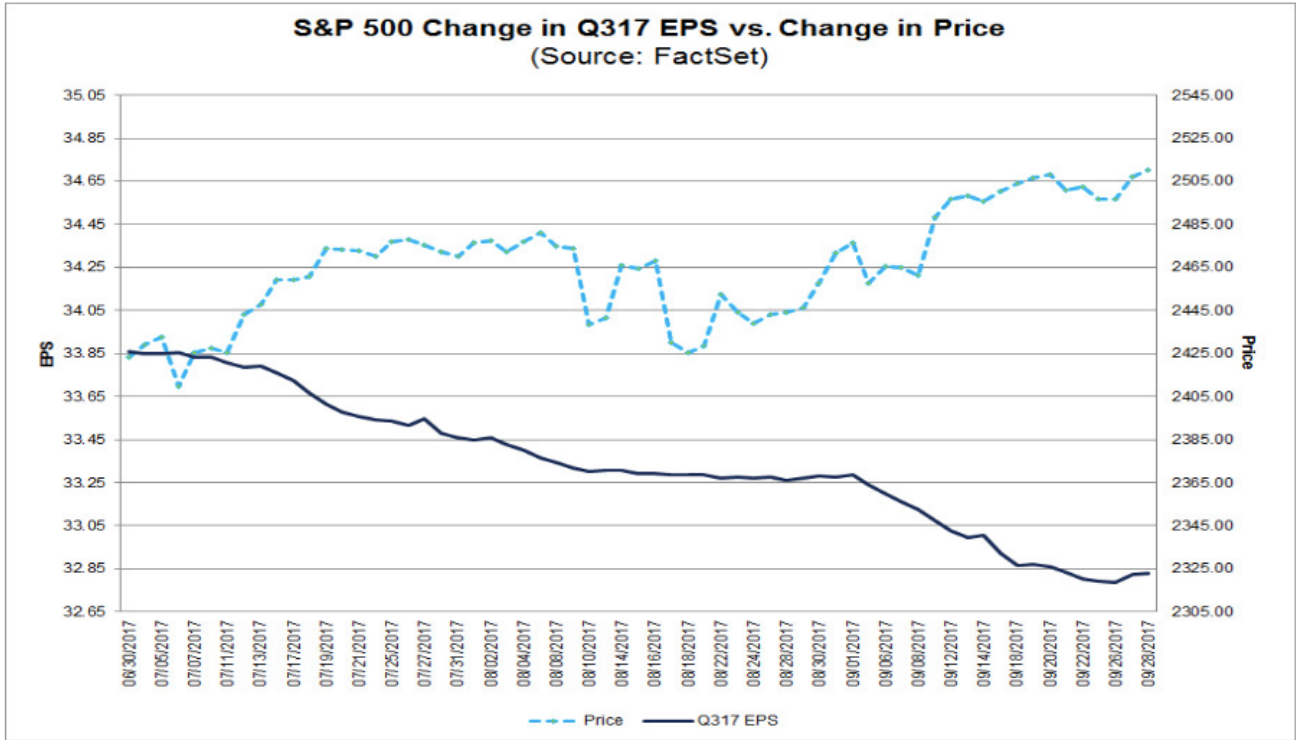
Well Inventoried J. Crew Children's Section



Source: *Business Insider*, [Inside the J. Crew Flagship Store](#)

This week represents the quiet before the third quarter earnings storm that will commence shortly. Since June, the overall Q3 S&P 500 earnings expectations have decreased 3% as the index has increased 5%.

Expected Third Quarter Earnings for the S&P 500 vs. Index Performance



Source: FactSet [“Earnings Insight”](#), September 29, 2017

Stillwater View: This spread will narrow. It’s just a question of which side does more of the narrowing.

On Tuesday, Warren Buffet made an appearance on *CNBC* to discuss Berkshire Hathaway taking a 38% stake in [Pilot Flying J](#). Pilot is the fifteenth largest private company in America, with 750 fueling stations and convenience stores nationwide. CEO Jimmy Haslam has visited 749 of them.

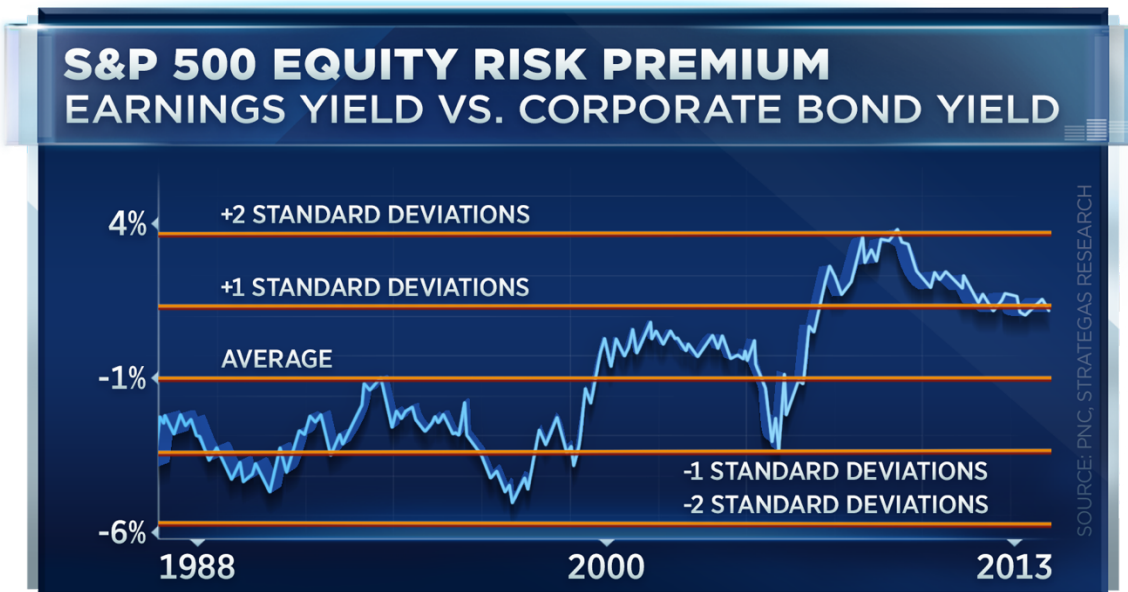
Pilot Flying J Gas Station and Convenience Store



Warren stuck around after the announcement to provide a full interview and [his thoughts](#) on tax reform, markets and valuation. Compared to the 2.3% yield on the 10-year Treasury, stocks are indeed a buy. If rates were closer to 5%, that would be a different story. “Over time, I still prefer stocks.”

PNC Asset Management’s Bill Stone took Buffett’s idea a step further. Concluding that there could be [upside of 32%](#) for the equity markets if consensus estimates for 2018 are met, even with corporate bond yields higher by 100 basis points.

Earnings Yield vs. Corporate Bond Yields Currently One Standard Deviation Above Average

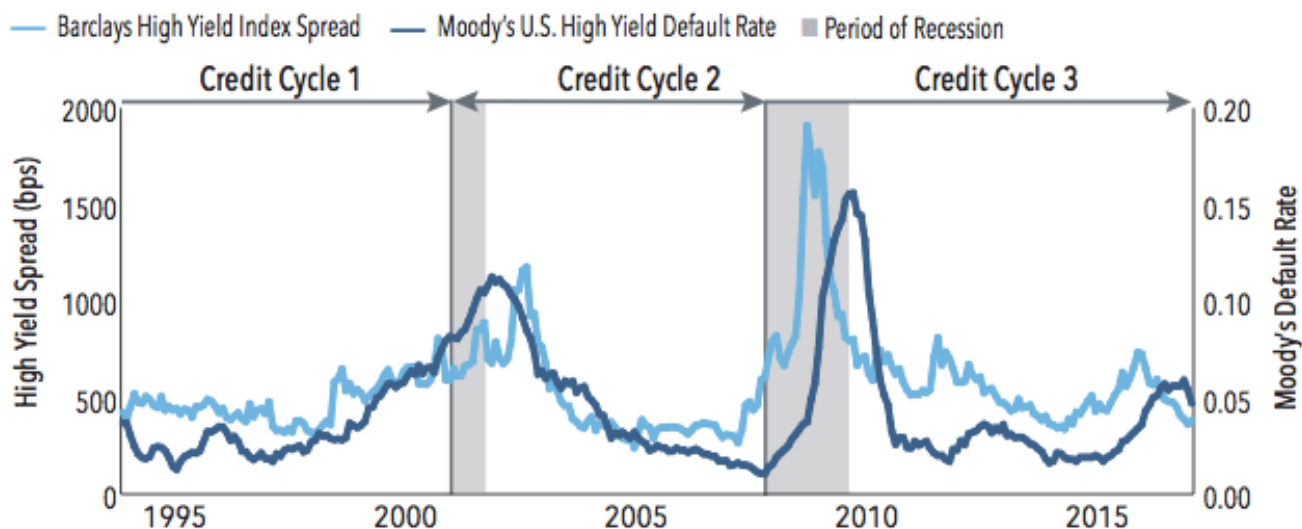


Source: PNC Bank & CNBC

Up and Down Wall Street

Marathon Asset Management is gearing up to take advantage of the next [global recession](#). The firm is looking to raise capital for a distressed debt fund to be there when a “bid wanted” opportunity arrives.

Credit Spreads and Default Rates During the Three Most Recent Credit Cycles



Data source: Barclays, Moody's from 12/31/93 to 3/31/17. Past performance is no guarantee of future results. Indices are unmanaged and unavailable for direct investment.

Source: Nuveen Investments, [“Where Are We in the Credit Cycle?”](#), May 2017

The recent headlines on Rockefeller and Guggenheim tell the tale of two iconic names seemingly headed in different directions.

This week [Rockefeller Capital Management](#) announced the hiring of Greg Fleming, the former head of Morgan Stanley’s wealth management division, to expand and grow the \$16.2 family office.

Rockefeller Capital Management Newly Named CEO, Greg Fleming



Fleming briefly ran Merrill Lynch and helped execute Morgan Stanley's CEO James Gorman's [plan to de-risk](#) the bank. He placed the more stable wealth management business as a priority ahead of the more volatile capital markets and trading divisions.

After the global financial crisis, Gorman famously said "Go ahead, run a hedge fund. Just don't do it on my balance sheet." The one business Mr. Gorman regrets losing was Peter Muller's PDT (Process Driven Trading). The money-printing quant machine inside the walls of Morgan Stanley was a casualty of the Volker rule. Mr. Muller would create a [new home](#) for himself. Opening shop and quickly receiving a \$500 million [allocation](#) from Blackstone.

Meanwhile, over at Guggenheim Partners the situation continues to [devolve](#). *Bloomberg* reports more than 60 bankers, traders and analysts have left the firm over the past two years. The rumors of discord forced the board to issue a recent memo that included a statement to dispel what was being leaked.

"We issue this -- a unanimous statement of Guggenheim's Board -- to set the record straight," the memo said. The board "affirms full and complete support" for leadership, and that "The firm is thriving, growing, stable and strong."

Guggenheim Partners New York Headquarters

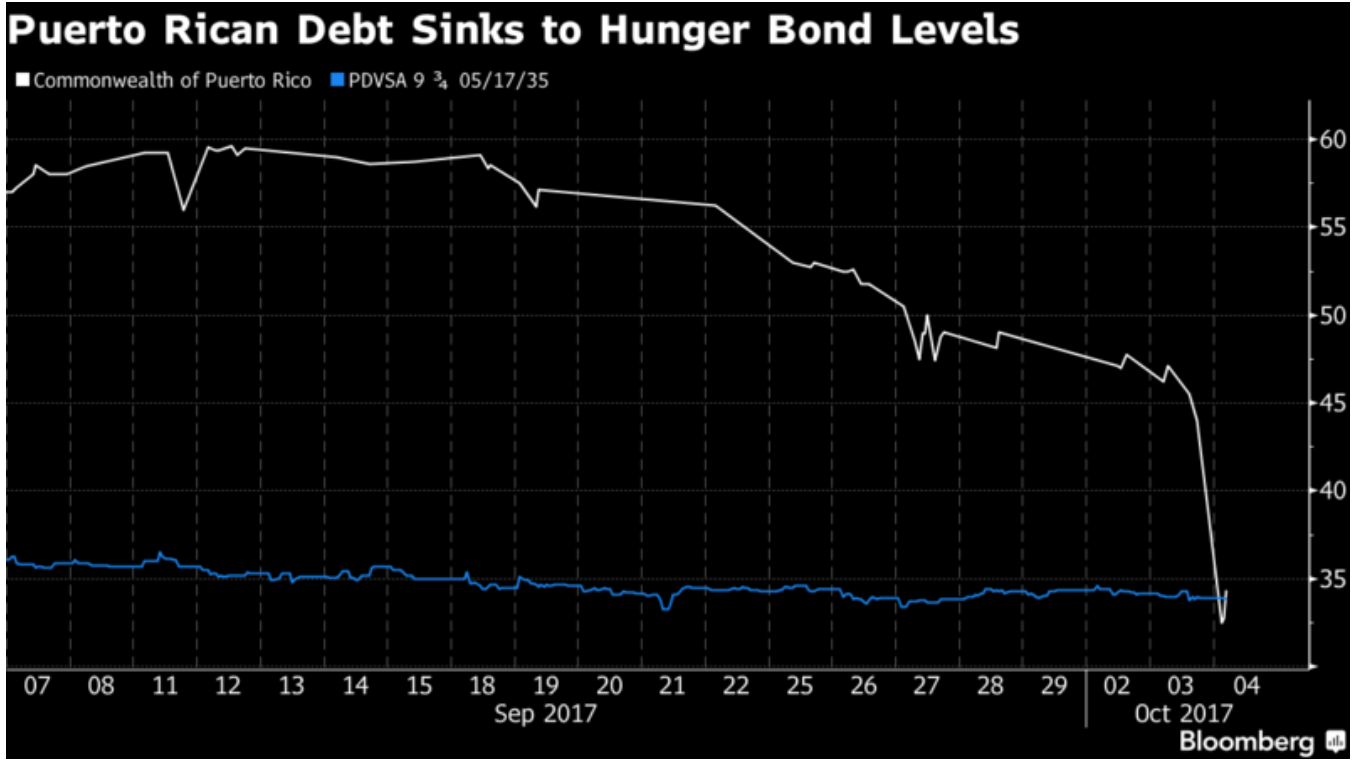


President Trump's visit to storm ravaged Puerto Rico included [unscripted comments](#) about erasing the territories debt. In an [interview](#) with Fox News correspondent Geraldo Rivera, the President said,

"We have to look at their whole debt structure. You know, they owe a lot of money to your friends on Wall Street, and we're going to have to wipe that out. You can say goodbye to that. I don't know if it's Goldman Sachs, but whoever it is, you can wave goodbye to that."

This roiled the market for the already stressed General Obligation bonds of the territory, sending the principal on some down 25% overnight. Once again, the White House wound up "[walking back](#)" the comments. Director of OMB Mick Mulvaney later clarified things by saying "I wouldn't take it word for word with that."

Single Issue Puerto Rican General Obligation Bond Due 2035



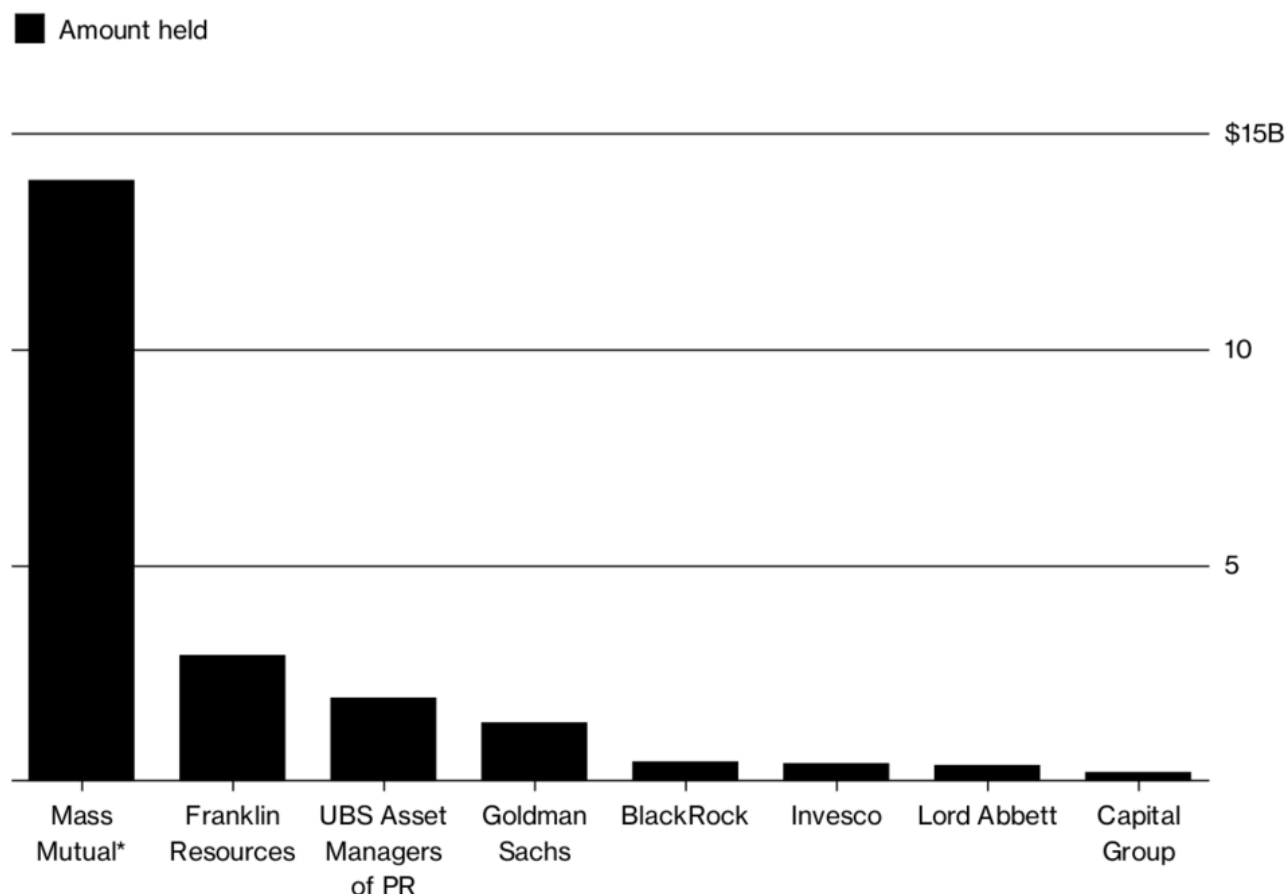
Source: Bloomberg

Federated CIO Stephen Auth, reminded us that [today's debt holders](#) own the credits for a completely different reason than those who purchased the original issuance.

Largest Holders of Puerto Rican Debt

Who Holds Puerto Rican Debt?

U.S. mutual funds are among the commonwealth's biggest institutional creditors



Source: Bloomberg

The Wall Street Journal reported on Tuesday that [“Hedge Funds Ain’t Dead Yet”](#). Making money again and taking in new cash, as a group, they are up 5.4% through the end of August, while equity focused funds gained 8.3% on average. During that period, the S&P 500 returned 11.9%. That’s 70% upside capture of the broad market return.

While it’s a stretch to say that the industry is back, just being relevant again would be a win. *Bloomberg* columnist Stephen Gandel takes the other side, writing that [“Hedge Funds are Still in the Dumper”](#).

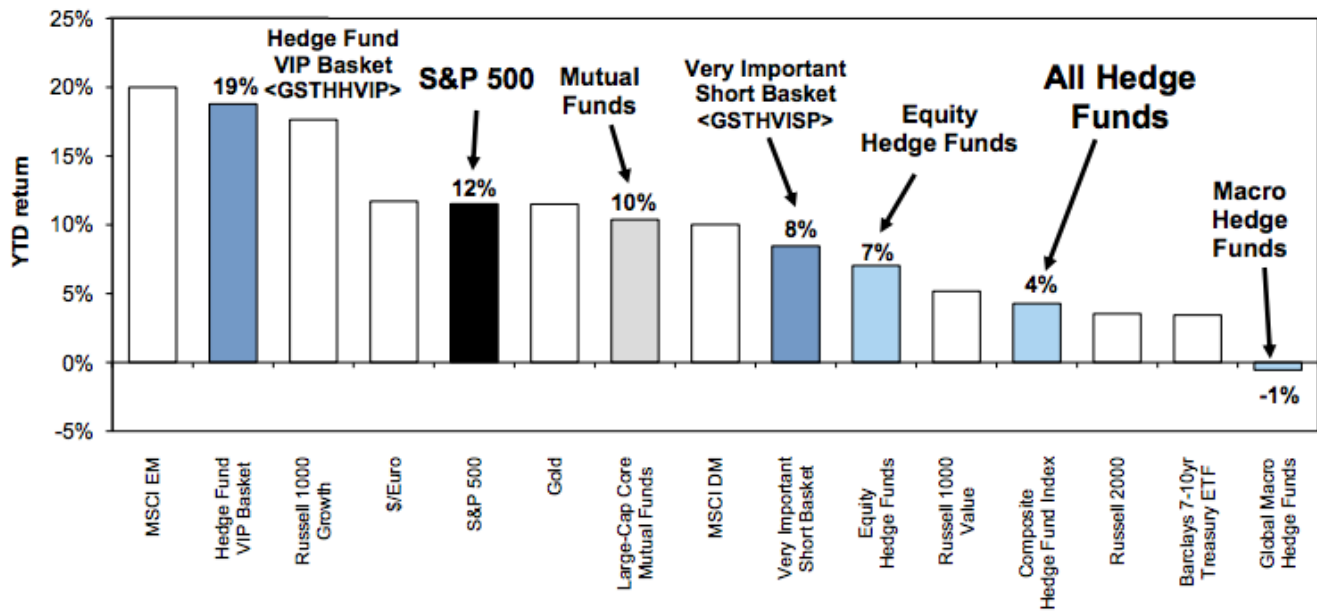
Stillwater View: The ‘80s and ‘90s are considered the Golden Age of hedge funds. Long/short strategies of that era tended to operate with a more flexible mandate than today. As a result, there was better upside capture. If the manager thought they had the long side right, they would often lever up to amplify exposure.

Fast forward two decades, and the world of hedge funds would now be inhabited with strategies of the low volatility kind. This was in part a result of the global financial crisis and increased demand for a more secure, yet lower, return promise. By and large, the industry stayed in flaps down mode for an extended period and relative performance suffered.

The greatest fear now, is that the groups recent pickup in performance is the result of managers reaching for return. Getting caught leaning long into the next meaningful correction would once again leave the industry with a black eye.

The Goldman Sachs Hedge Fund Very Important Position (VIP) Basket Beat Almost Everything Through Mid-August

Exhibit 2: The most popular long positions have lifted equity hedge funds to a 7% YTD return as of August 14, 2017



Source: Goldman Sachs & Business Insider

The firm converted their research into the [Goldman Sachs Hedge Fund VIP ETF](#). While small at \$50 million in AUM, the 49 stock holdings list is instructive as to where long/short equity funds are currently invested.

Diversions

The Major League Baseball playoffs kicked off on Tuesday when the New York Yankees took down the Minnesota Twins 8-4 in the ALCS Wild Card game. On Wednesday, the Arizona Diamondbacks advanced with a 11-8 victory over the Colorado Rockies in the NLCS Wild Card.

With those formalities out of the way, get ready for the real action to continue later today when the [Red Sox take on the Houston Astros](#) in Game 2. The [Yankees meet the Cleveland Indians](#), the

former also having dropped game one. The winner will ultimately play for the American League crown. Over in the National League, the [Cubbies take on the Nationals](#) at 2:30, the first pitch of the nightcap between the [Diamondbacks and the Dodgers](#) happens at 10:30 ET.

Stillwater View: As those of you who are regular readers know, Stillwater Capital is not terribly good at predicting sporting outcomes, though we are working really hard on it. We hope the Dodgers can make a run at a title, but understand that hope is not a strategy.

For sheer entertainment purposes, readers should be pulling for the Yankees to meet the Red Sox in the ALCS. If so, look for Diversions to release an onslaught of references to how great [Bucky Dent](#), [Aaron Boone](#) and The Captain were. And why the 1977 team was the greatest collection of modern day athletes the world has ever known.

The 1977 New York Yankees



1977 NEW YORK YANKEES WORLD CHAMPIONS

Back Row — CARLOS MAY, KEN HOLTZMAN, DICK TIDROW, CHRIS CHAMBLISS.

Middle Row — GERRY MURPHY (Traveling Secretary), GENE MONAHAN (Trainer), GRAIG NETTLES, REGGIE JACKSON, SPARKY LYLE, MICKEY KLUTTS, MIKE TORREZ, RON GUIDRY, GEORGE ZEBER, WILLIE RANDOLPH, LOU PINIELLA, DON GULLETT, KEN CLAY, GIL PATTERSON, ED FIGUEROA, CLIFF JOHNSON, PAUL BLAIR, HERMAN SCHNEIDER (Trainer).

Front Row — BUCKY DENT, ROY WHITE, ART FOWLER, CLOYD BOYER, DICK HOWSER, BILLY MARTIN, ELSTON HOWARD, BOBBY COX, YOGI BERRA, FRED STANLEY, THURMAN MUNSON, FRAN HEALY, CATFISH HUNTER.

Seated on Ground — (Batboys) JOE D'AMBROSIO, FELIX MARTINEZ, JOHN CALDARAO.

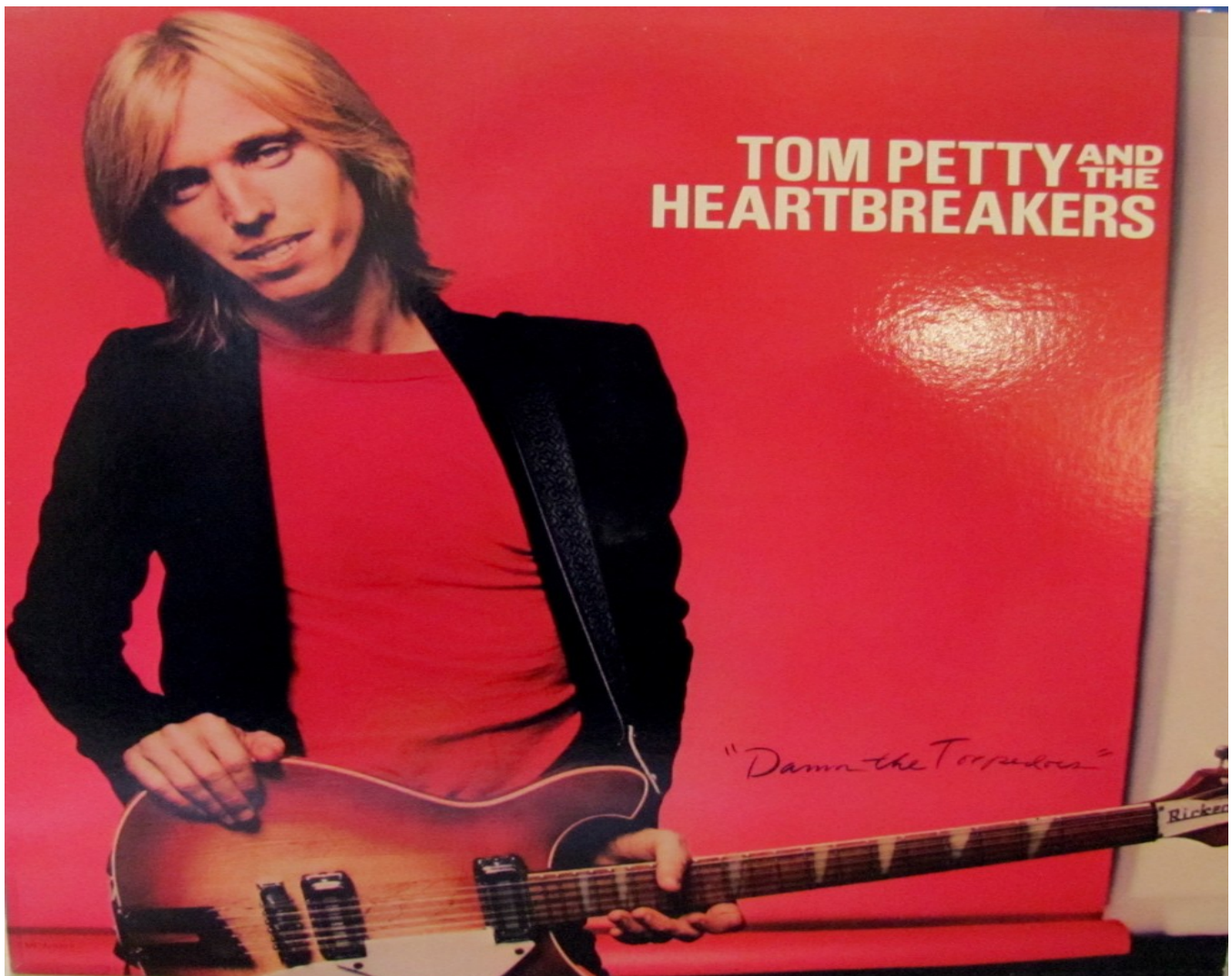
Absent From Photo — MICKEY RIVERS, PETE SHEEHY (Equipment Manager).

The legendary Tom Petty passed away on Monday. Joining fellow Traveling Wilbury members Roy Orbison and George Harrison on the big tour bus in the sky. They indeed took it to the [“End of the Line.”](#)

Petty will be forever remembered as a special soul. Singing about life growing up in the San Fernando Valley, [“Free Fallin”](#). Petty did the unthinkable when he made the Galleria look cool.

Later in the week, the L.A. Times printed the [last interview](#) before his death at the young age of 66. Diversions favorite, [“Don’t Come Around Here No More”](#).

Tom Petty and the Heartbreakers, “Damn the Torpedoes”



All [five former](#) U.S. presidents will gather later this month in College Station, Texas for a [concert to benefit](#) those impacted by hurricanes Harvey, Irma and Maria. “Deep From the Heart” will feature Alabama, Lyle Lovett, the Gatlin Brothers and [Robert Earl Keen](#).

Texas, where the [“Road Goes on Forever”](#) and the party never ends.

A Quarter Century of American Leadership Together in the Oval Office



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