Stillwater Capital and Partners

Before we venture into the top-down and bottom-up this week, we would like to add a little more granularity to last week's discussion of what we do and who we partner with here at Stillwater.

Keep in mind, our main objective is to deliver to our readership what's happening in the markets and the economy. This is however, still a profit driven commercial venture, so from time to time we talk about the business and its ongoing development. Read on, or if you prefer, feel free to scroll down if you want to get straight to the markets. Either way, we appreciate your interest and comments.

To begin, Stillwater is a registered investment advisor (RIA) in the State of California. Our business can be broken down into two pieces; on one side there is wealth advisory, where we look for the best solutions to meet a client's financial objective, while the other side consists of alternative equity strategies built and managed by our firm.

In wealth management, we take an agnostic viewpoint and maintain the ability to recommend anything from a straight down the fairway municipal bond ladder or equity ETF, to a higher yielding real estate partnership or alternative fund. The goal being to determine what you need the assets to do and then go out and find the best solution to achieve your goals.

The advantage we retain through our partnerships benefits our investors by way of the ability we have to assist if the solution requires a greater degree of financial planning or specialization.

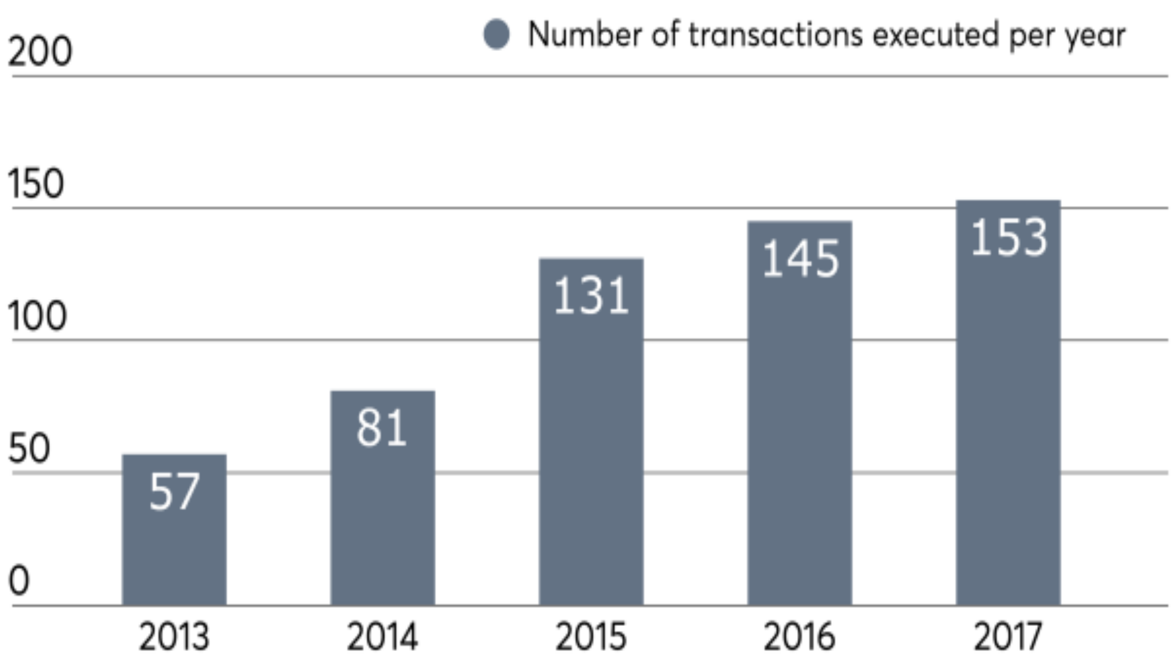
As a result, we may refer you to our partners at Canter Wealth in La Jolla or Balboa Wealth Partners in Newport Beach, with whom we collaborate. We provide the former with portfolio management and implementation services and the latter as an alternative equity strategy provider.

With ample capacity at Stillwater we welcome the opportunity to have the conversation with advisors or teams looking to find a platform that allows them to focus on client engagement, business development and planning, while we assist them in supporting the investment side of the business.

Our partners at The Riviera Group can help put that conversation on a fast track to completion with their professional focus on practice valuation and business economics.

Simply said, we know what our strong suit is here at Stillwater Capital, and through our advantageous partnerships we possess an ability to bring to the table a greater optionality, benefiting both our investors and our partners in the pursuit of continued growth. Whether is comes from a passive or active source, we are very interested in participating in the consolidation wave.

Deals on the Rise



Source: DeVoe & Company

The other side of the ledger focuses on the management of alternative equity solutions. These are bespoke strategies designed to perform differently from the overall market. They may do so through sector or stock concentration, and some degree of hedging to reduce volatility and provide protection in a down market.

These strategies are branded as Stillwater Trinity Equity. The "Trinity" refers to three things that make them work: these are long investments, short positions and cash. In our view the holy trinity needed to produce positive absolute performance regardless of market condition.

While unofficial at this moment, Stillwater looks forward to and is hopeful to announce our partnership with an asset manager in Los Angeles which will result in our ability to sub-advise certain liquid alternative strategies.

The aforementioned firm currently has $300 million under management in alternatives and we will be running hedged equity portfolios in separately managed accounts with a mutual fund on the horizon. Another wave we think is certainly worth riding.

Barron's Profiles Liquid Alternatives

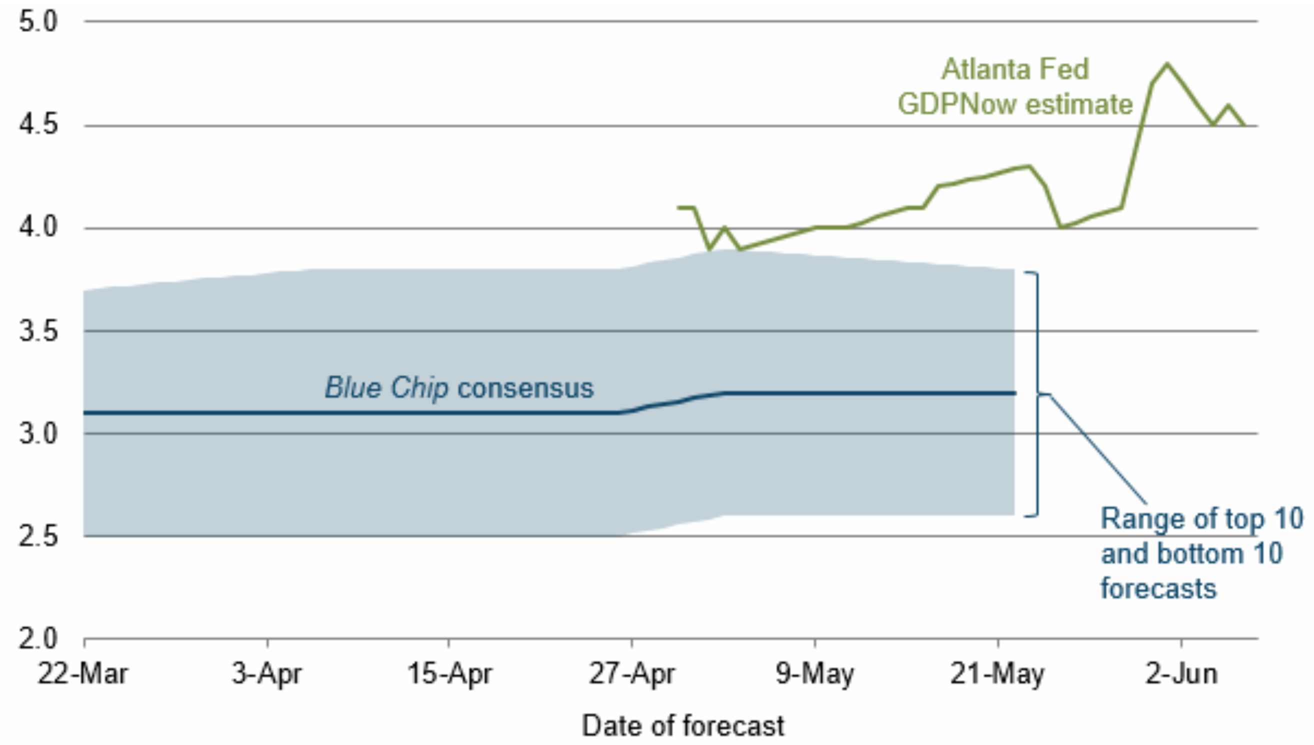
Source: Barron's

That it for the deep dive and update on Stillwater Capital for now, back to "This Week in the Markets"

<u>The Top-Down</u>

The economic narrative continues to shift from global synchronous growth, to one where the U.S. is now carrying the weight of the world as we power ahead. Climbing to 38,000 feet at 400 knots into ever cleaner air.

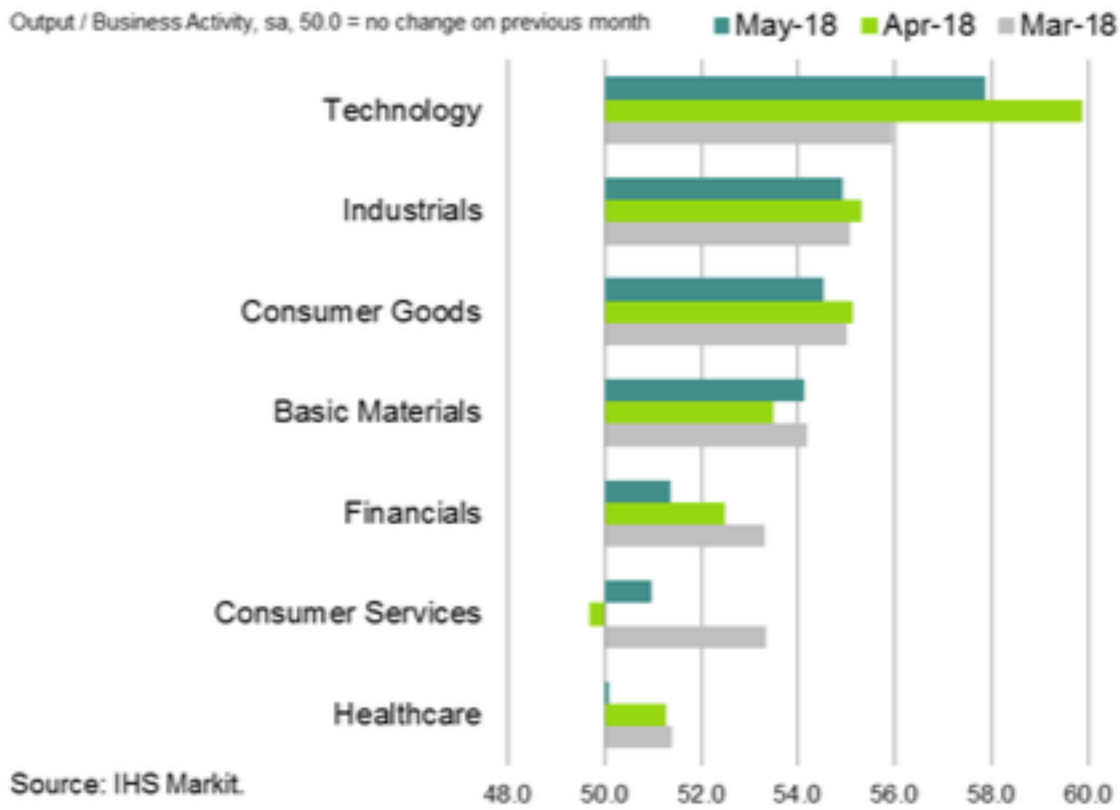
Atlanta FED GDPNow



Source: Atlanta Federal Reserve

Europe is showing signs of economic deceleration with continued evidence that the threat of trade war is taking a toll. This week the IHS Markit PMI showed all sectors looking less robust in May than they did in April.

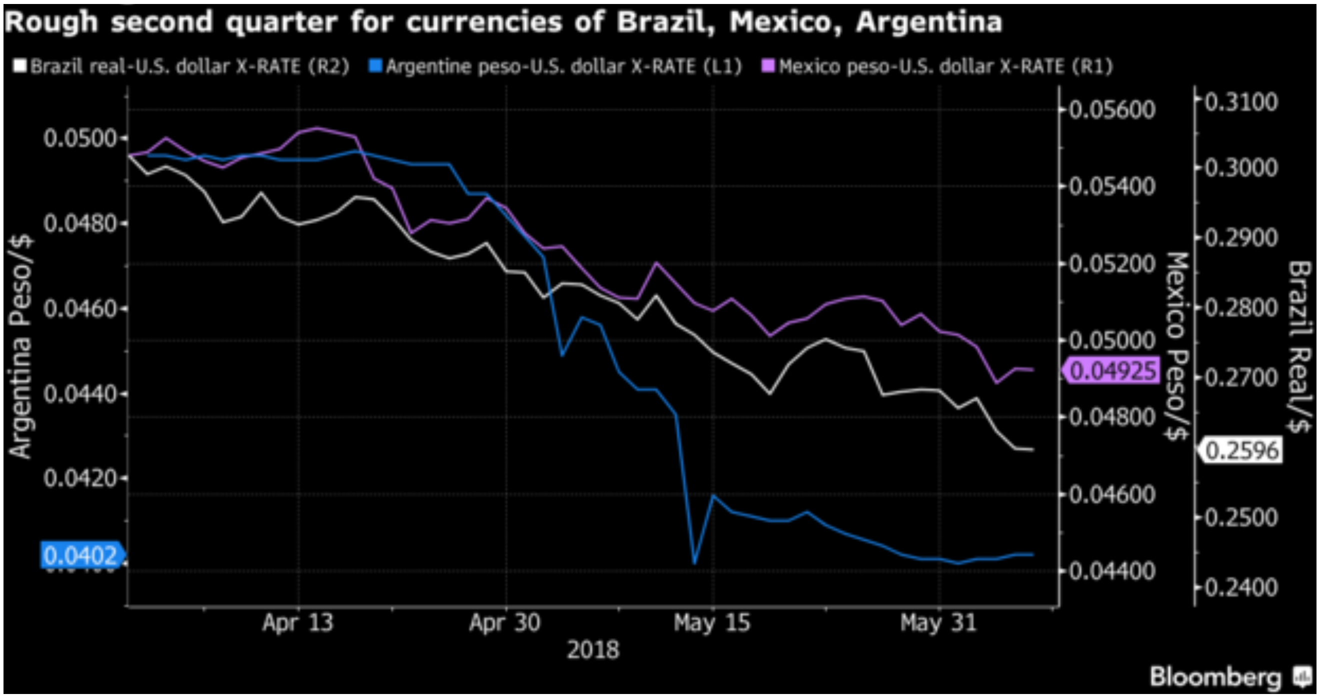
Eurpean Sector PMI



Source: HIS Markit

Meanwhile, emerging markets around the globe are dealing with slower growth and rising currency headwinds as rates in the U.S. head higher.

Taking A Hit



Source: Bloomberg

The one silver lining to the newly clouded economic skies is the strong rebound in the Baltic Dry Goods Index thus far in June. The BDI tracks freight rates for raw materials around the globe, and is a good indicator of demand for industrial commodities and economic strength.

Baltic Dry Goods Index

Source: Trading Economics

The markets have taken notice, sending the U.S. into a strong mid-year rally while the rest of the world looks on.

The S&P 500 is up 3.7% in the past 30 days, while the European STOXX 600 is down 1.5% and the MSCI Emerging Markets Index is down 1.0%.

Stillwater View: To quote Ron Burgundy, "That escalated quickly, I mean really got out of hand fast!" The "long the United States, short the world" trade has started to work well…fast.

Ron Burgundy Gives Us the Thumbs Up

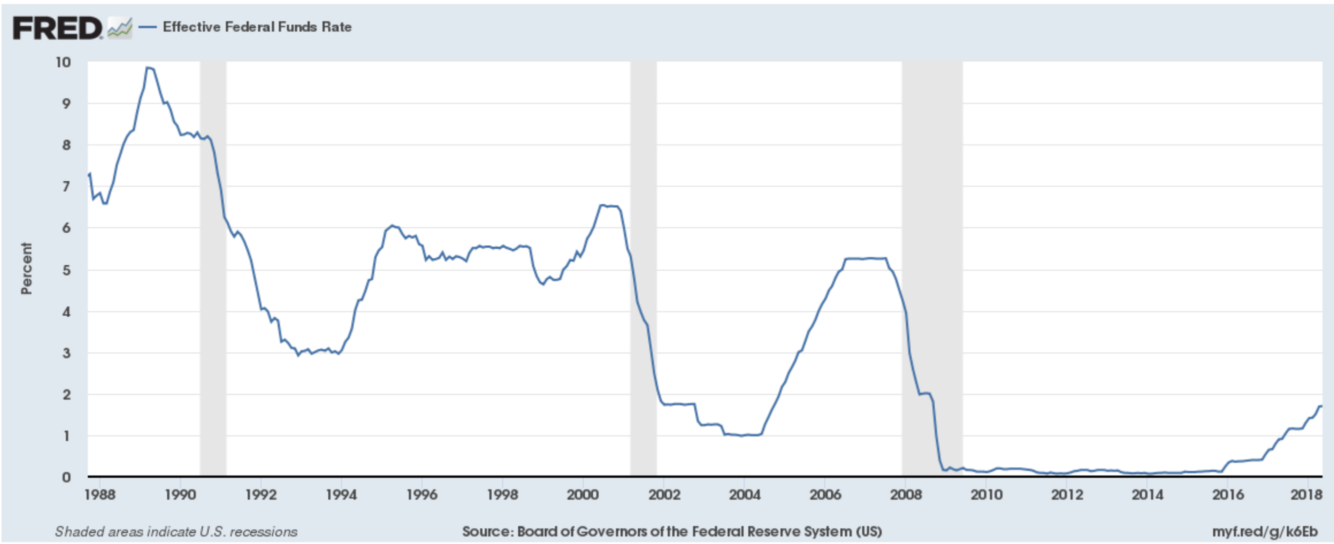
Source: YouTube

More and more this is looking like the "cleanest dirty shirt in the hamper" narrative whereby we were the market of choice during the recovery as the best of the soiled bunch.

This time, we are talking about the "nicest new shirt at Barney's", as the U.S. and world economies are taperig off of the quantitative easing drip and running on their own.

Goldman Sachs chief economist Jan Hatzius wrote a piece this week that described the current U.S economic performance as probably "as good as it gets". The firm expects above trend growth to provide ample cover for the Fed to raise rates every quarter for the next seven. That's a cycle we can rely on to take us out to this time in 2020, with the Fed Funds rate projected to be double what it is today.

Thirty Years of Lower Lows



Source: St. Louis Fed

Haitzus went on to caution that while this may indeed be as good as it gets, don't walk away from the markets as economic growth should remain above trend for a while.

Market veteran Byron Wien agrees. The smart people over at Bridgewater don't. And Ben Bernanke thinks the economy is going to go Wile E. Coyote in 2020. In other words, it's not quite time to ask Katie to "bar the door".

Catherine "Katie" Douglas Bars the Door

Source: Quora.com

Stillwater View: At Stillwater our weekly commentary provides a lot. And by a lot, we mean not just financial market news and analysis. So in the spirit of knowledge, may we reminded you that "penultimate" doesn't mean the "the best", it means "second to the last", as we now give you further cocktail party fodder by explaining the meaning of "Katie, bar the door."

The phrase, which is a reference to an attempt to guard against impending doom, dates to 1437 when Catherine "Katie" Douglas, tried to save Scottish King James I from an unruly mob. The King had retreated to a room with a door, but the doors locking bar was missing. Catherine tried to save him by using her arm instead. Sadly, for both, it didn't work out. As the story goes, the King's pursuers broke Katie's arm and wound up murdering him despite her attempt to provide a safe harbor.

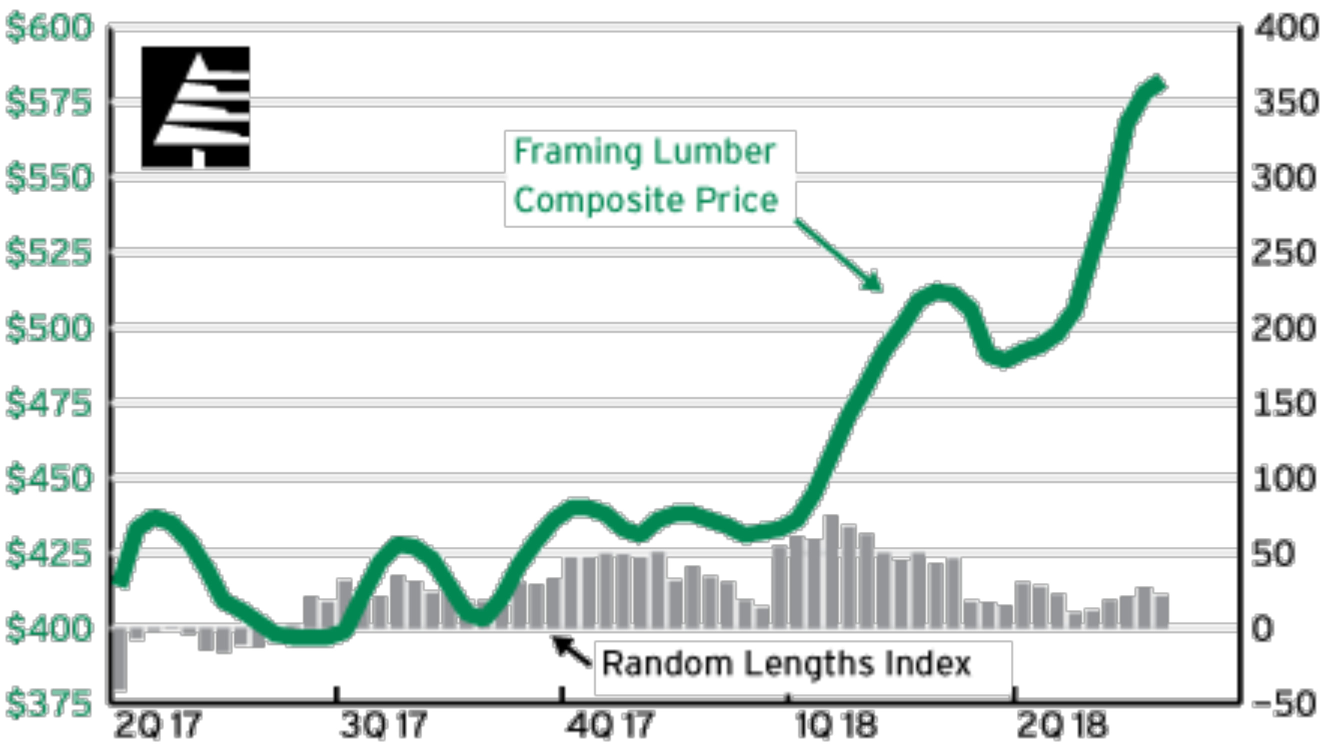
The lesson? If trouble is headed your way, make sure you have the proper tools to ward it off. As we get later and later into the economic cycle, it becomes even more imperative that the Fed normalizes rates, if for no other reason than to have dry powder when the economic skies darken once again.

Next week, what it means to give something "the whole nine yards."

The Bottom-Up

Don't think inflation is real? Lumber prices are saying otherwise. Through a combination of high housing related demand and the tariff risk to Canadian manufactured wood, the material is getting squeezed higher and is up more than 35% this year. We have already seen this hit homebuilders.

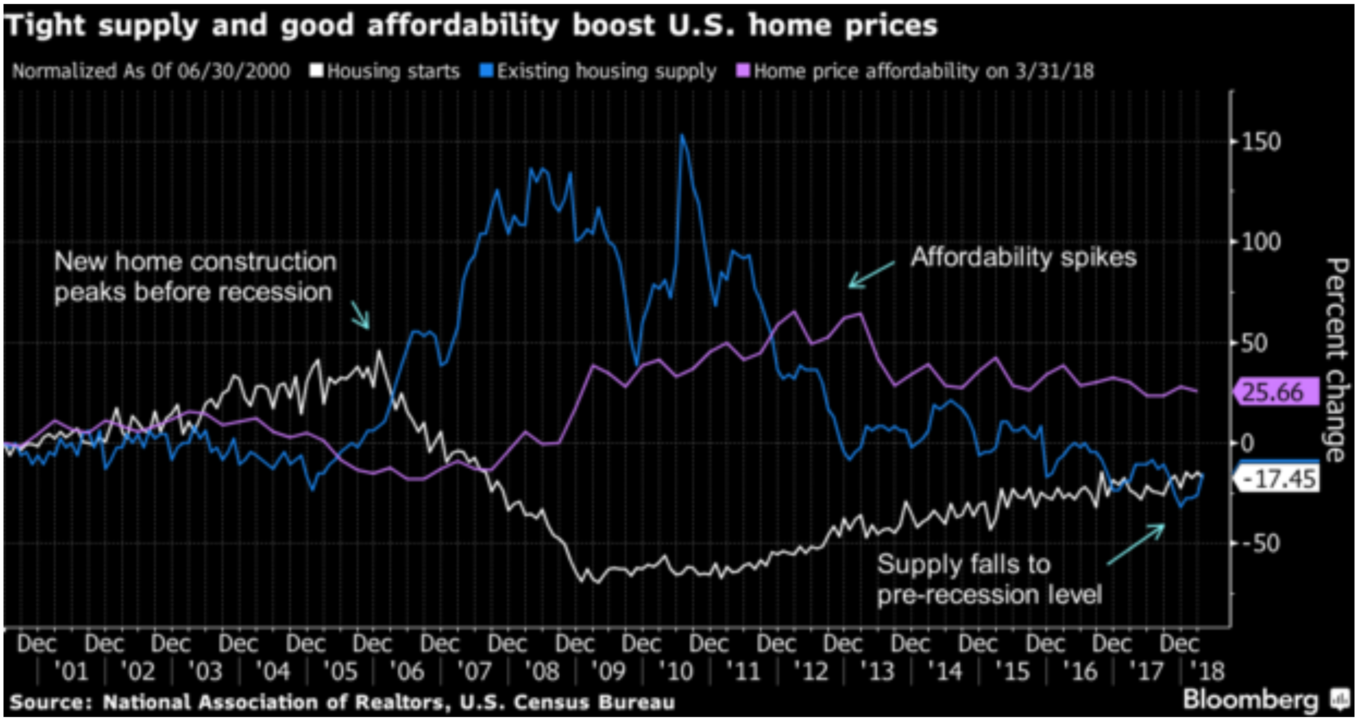
Random Lengths Lumber Pricing



Source: Random Lengths

The situation with lumber is endemic of the challenges faced by the housing industry. Right now we are sitting in a perfect storm of low inventory, high prices, and lack of affordability. This busy chart from *Bloomberg* tells the story.

Supply & Affordability Down with Prices Up



Source: Bloomberg

Stillwater View: Some call it a crisis, others just say there are structural headwinds. Either way, the setup for housing and home creation is not a good one right now. It's roots go back to Ben Bernanke's plan to reflate assets with ultra-low rates and monetary accommodation. Turns out it worked but wages haven't followed suit.

If you had assets and held on through the Great Recession you have been made whole, and then some. On the flipside, if you are on the outside looking in you are SOL. Especially if you are living in the San Francisco Bay Area. In case you are wondering, SOL is a technical term.

Equity futures were weak this morning, signaling a softer open. Much of the blame can be placed on the rumor once again that Apple is seeing a material weakening in iPhone demand. This report, coming from Japan's Nikkei, had the company telling suppliers to ratchet back production by 20%.

Below is what is called a "tear down" of the iPhone X. It's common on Wall Street when a new product is launched to get your hands on one and dissect it. This tells analysts which companies were "designed in" and how much content they contribute. Samsung has the highest dollar value exposure.

iPhone X Tear Down

Source: C|Net

Elon Musk got his short squeeze this week when shares of Tesla rose 10% on the news that the company was going to move forward and open a production facility in China and that the current "production hell" being experienced on the line can only get better. In early May, the 46-year-old Musk tweeted that a "short burn" was coming with "flamethrowers arriving just in time."

Elon Fires Up the Shorts

Source: TechRadar

Stillwater View: You call that a short squeeze? I'll show you a short squeeze! Shares of one of the markets other most heavily bet against names, Advanced Micro Devices, have risen more than 50% since early May. Quadruple the size of the move made by Tesla.

AMD vs. Tesla

Source: Nasdaq

In honor of the full disclosure and transparency we preach at Stillwater Capital, we pass along that both AMD and TSLA are stocks currently held short. The latter is still slightly in the black while the former has cost us about 100 basis points in performance. Nothing to lose your mind over, but in a low return year you hate to give up that much on a single name. Therein lies the challenge in this market.

Up and Down Wall Street

Jaime Dimon and Warren Buffett say it's time to retire quarterly reporting and we could not agree more.

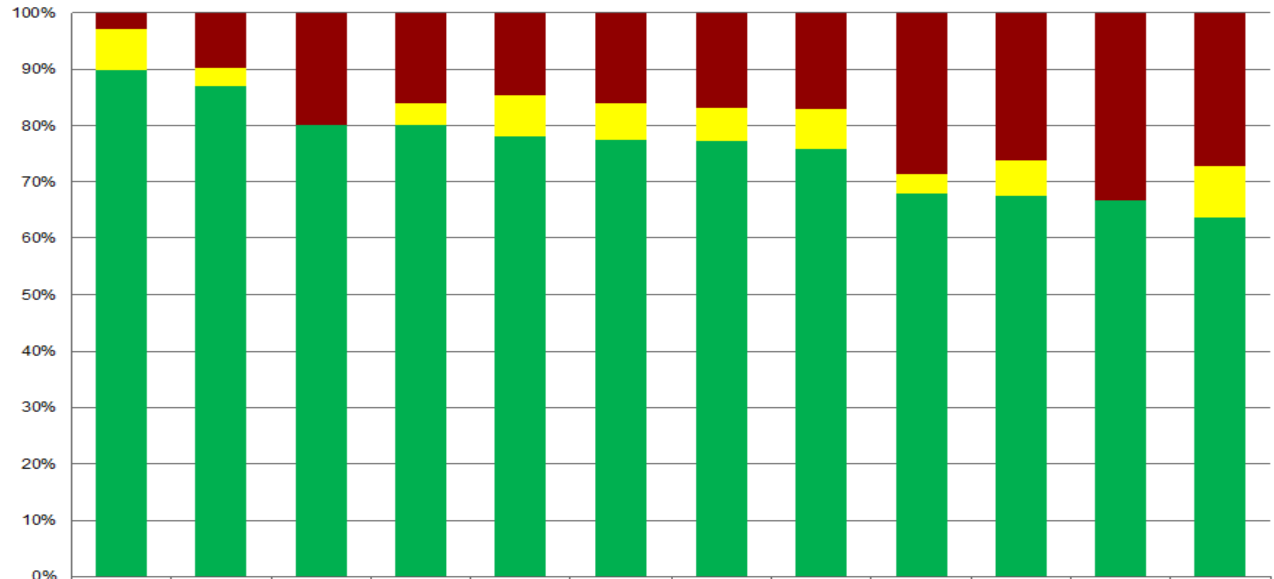
In an Op-Ed titled "Short-Termism is Harming the Economy" that ran in the *Wall Street Journal* they argued that trying to run a public company on 90 day business cycles is bordering on the absurd.

Modifying the reporting rule to have companies open the books twice a year is more than enough. With the only caveat being that material events still need to be disclosed in a timely manner.

Honeywell's former CEO Larry Bossidy let his reservations be known on CNBC saying that "short-term gives you some focus; long-term gives you future".

Looking at the first quarter earnings for 2018, if 70% of earnings come in "above consensus", how useful are they? Or are we supposed to believe that "directionally accurate" does the trick? This begs the question, what's wrong with Wall Street's estimate making machines?

Earnings Above, In-Line, Below Forecast in Q1 2018



	Info. Technology	Health Care	Consumer Staples	Materials	Financials	Energy	S&P 500	Industrials	Utilities	Consumer Disc.	Telecom Services	Real Estate
Below	3%	10%	20%	16%	15%	16%	17%	17%	29%	26%	33%	27%
In-Line	7%	3%	0%	4%	7%	6%	6%	7%	4%	6%	0%	9%
Above	90%	87%	80%	80%	78%	77%	77%	76%	68%	68%	67%	64%

Source: FactSet

Stillwater View: As mentioned earlier, we strongly agree that the quarterly practice of reporting isn't good for companies, investors or the economy. I honestly believe that changing the mindset would go a long way to establish longer range thinking amongst the investor class.

And should the rule change, we will be the buying the first, second and third round of drinks at Fraunces Tavern to celebrate the demise of analysts fawning over management as if they needed a real job with the obligatory "Great quarter guys".

Fraunces Tavern – New York City

Source: New York Magazine

On the subject of Warren Buffett, the bull market in lunch with the man is back on. This year's winner paid $3.3 million, well above last years $2.8. Hedge fund manager Ted Weschler won the auction in 2010 and 2011, paying a combined $5.25 million for two lunches. Turns out it was money well spent as Buffett wound up offering him a job running the portfolio alongside Todd Combs.

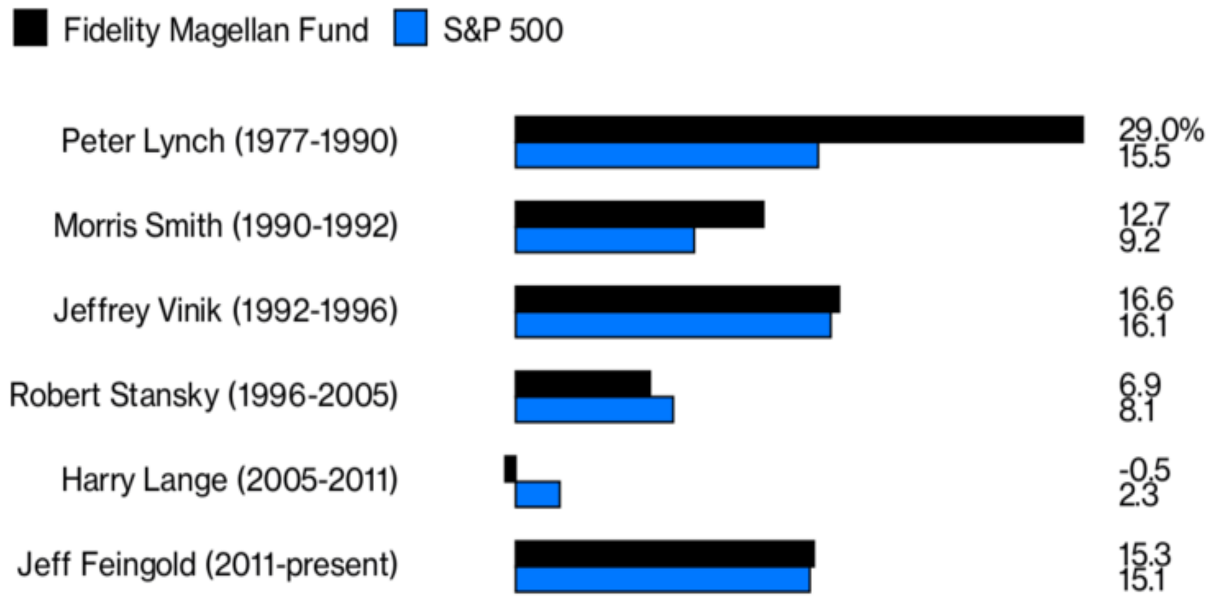
Berkshire's Top Equity Picking Brass – Buffett, Combs and Weschler

Source: Bloomberg

As a reminder of how brutal the last twenty years have been for the active equity manager, *Bloomberg Businessweek* ran a story detailing the random walk of the Fidelity Magellan mutual fund since it peaked 18 years ago.

To refresh ones memory, if you owned a stock fund in the '80s chances are good you owned Magellan. Peter Lynch, and later Jeff Vinik, could do no wrong for you. Fast forward to today and the fund is down to $17 billion from its peak at $110 in 2000. Since then investors have pulled money for 18, yes 18, straight years!

Magellan's Performance



Source: Bloomberg Businessweek

Stillwater View: What more can you say than "easy come, easy go". Being an equity analyst and portfolio manager is one of the best gigs out there. That is if you can find it. For the intellectually curious it's the greatest job in the world. It just simply doesn't pay what it used to.

Diversions

This should be one of the most exciting times in sport right now with the NBA Finals in full swing and the Stanley Cup taking place. Turns out not so much as the series between the Cavs and Warriors looks more like a mid-season snoozefest.

On the ice, the Washington Capitals won their first Stanley Cup last night. Beating the upstart Las Vegas Golden Nights 4-1 in the series.

But onward we venture as the Belmont Stakes takes place tomorrow and Justify has the chance to become the second horse in recent memory to win the Triple Crown after American Pharaoh took it in 2015.

Current odds are 4/5 and he is in the number one post. George Soros has part ownership of the horse.

Justify Takes the Kentucky Derby

Source: Sporting News

Up next week, a very special U.S Open coming to you from the storied Shinnecock Hills Golf Club in Southampton, New York. The club will have hosted the Open four times after this years.

Shinnecock Hills Golf Club

Source: Golf Digest

Graduation season is winding down as the last classes walk on the stage to Pomp and Circumstance. And that's just what the Santa Barbara High School class of 2018 did yesterday in the sun splashed Santa Barbara County Bowl.

Special Night at the Bowl

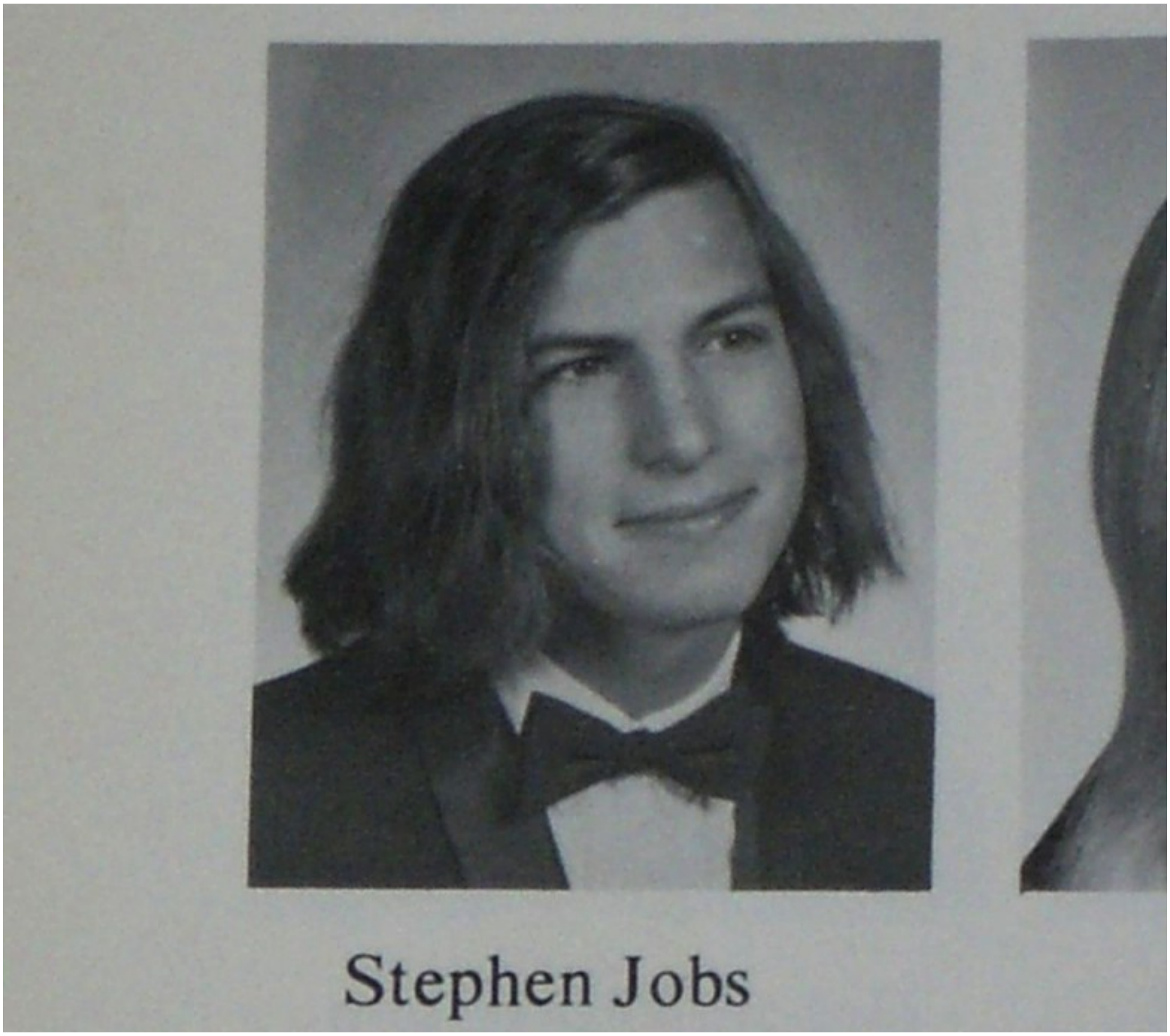
Source: Noozhawk.com

Stillwater View: Congratulation to all the kids we got to watch grow up over the years. A special acknowledgement to one Robert "R.J" Goligoski for making being a parent look so easy. Now go make this life your masterpiece.

In case anyone needs further inspiration remember what Admiral William McRaven told the graduates at UT, "never ring the bell". Or what Steve Jobs counseled at Stanford in 2005, "Stay hungry. Stay foolish."

He of course meant to also say "Go Mustangs" but left it out on accident. At least that's what we choose to believe.

Steve Jobs – Homestead High Class of 1972



Source: Cult of Mac

Stillwater View: Go Mustangs!

While the news is still too fresh, and almost too sad to believe, Anthony Bourdain left this world earlier today. For those who loved food, wine, and what looked to be a really good time, the passing of this true raconteur will leave a huge void.

If you loved Tony like I loved Tony, find time to raise a fork or tip a glass to him this weekend.

Anthony Bourdain 1956 - 2018

Source: Study Breaks

Stillwater View: You, my friend, will be sadly missed.

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