



July 21, 2017

Stillwater Capital Update

This Week in the Markets will be transitioning to a new distribution platform next week and going forward it will be easier to subscribe and share content. If, by chance, you are lost in the changeover please send an e-mail to contact@stillcap.com and you will be added back to the distribution list.

[Strategic Investor Radio](#) host Charley Wright and I sat down last Friday to discuss hedge funds and the investing landscape. The interview will air soon with a podcast of the program to follow. In the meantime, you can hear my conversation on alternative investing with Neil Krisel and [Arlington Financial's](#) Dianne Duva from 2016 on [Money Talk](#) Radio.

The Top-Down

Allianz chief economic advisor, Mohamed El-Erian, provided his opinion that equity investors should enjoy the [liquidity-driven market](#) for a little longer. But beware, the enjoyable destination remains more elusive.

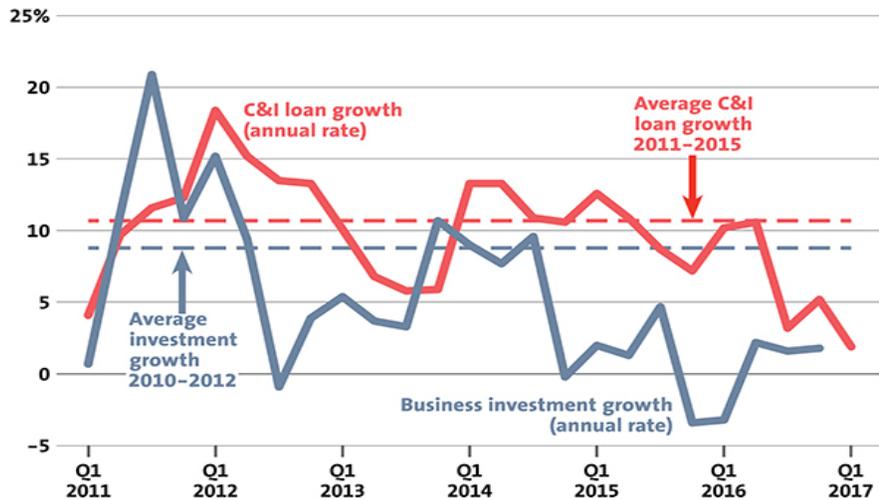
China GDP [grew at a 6.9% pace](#) in the second quarter. This was stronger than most anticipated and pacified the credit bubble bears for now. Stephen Roach, the former head of Morgan Stanley Asia, views the economy there as [far more resilient](#) than the market is currently discounting.

Stillwater View: China has become less of a swing factor in the global economy of late. This was not the case a decade ago when it had a bigger seat at the table. The second quarter GDP report put a small bid into the commodities and materials sectors, and for the second week in a row crude oil held it's rally. If China can baseline at 6.0% growth the rally in materials is likely to be real.

Stephen Roach has more boots on the ground experience in China than almost anyone on Wall Street. His [commentary](#) on the country is well worth listening to. In the 1990's he, along with Blackstone's [Byron Wien](#) and the late Barton Biggs, combined to form the public facing investment committee for Morgan Stanley. Their weekly Investment Perspective was required reading. Wien almost always bullish, Biggs constantly bearish with Roach spinning various data points into an ever-evolving emerging markets collage.

There has been a decided slowdown in commercial and industrial lending since the start of the year and the market is beginning to take notice. The Milken Institute [wrote about it](#) in April. Their conclusion at the time, Dodd-Frank was forcing banks to focus on larger more profitable loans. Making it harder for smaller firms to find the financing they desperately need.

INVESTMENT SLOWED BEFORE C&I LENDING

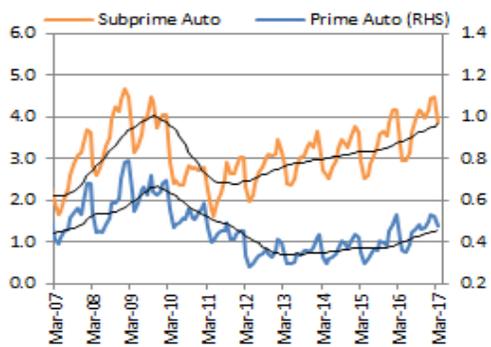


source: The authors

The often-mentioned sub-prime auto loan market continues to deteriorate. This week Patricia McCoy, law professor at Boston College and Gary Pieples at Syracuse [discussed the subject](#), drawing parallels with sub-prime mortgages a decade ago. BB&T CEO Kelly King takes the other side, saying that the [risk is overblown](#). While defaults are higher in sub-prime, in King’s estimation the higher yield makes up for it.

Exhibit 1:

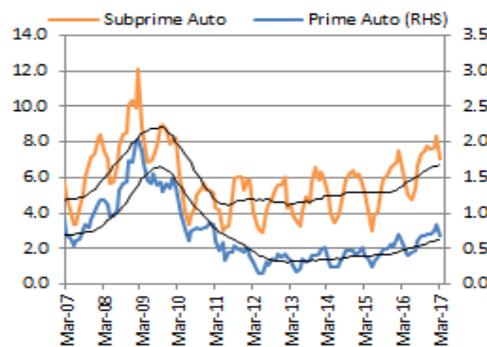
60+ Days Delinquent (%)



Source: Intex, JPMIM; data as of April 2017

Exhibit 2:

Annualized Net Loss Rate (%)



— 12 Month Moving Average

Stillwater View: These two trends in lending tend to signal the economy is in the latter stages of expansion. No one data point indicating a sell, but the 12 to 24-month picture coming into focus isn't good for a fully valued market.

The Bottom-Up

Chipotle Mexican Grill was hit again this week by a [food safety scare](#) at their Sterling, Virginia location. Activist investor Bill Ackman took the opportunity to [tweet about it](#).

Nelson Peltz has turned his “[constructivist](#)” version of activist investing on Proctor & Gamble. Citing [weak shareholder returns and deteriorating market share](#) as the reason he wants a board seat.

Bank earnings continued to roll out this week. There was the good, [Morgan Stanley](#). The bad, [Goldman Sachs](#). And the ugly, [J.P Morgan](#). Jaime Dimon, let loose during J.P Morgan’s conference call saying it’s “[almost embarrassing being American](#)” overseas.

Stillwater View: Crosscurrents are everywhere in the banking waters. Trading revenue down for some and up for others, lending has slowed, the yield curve isn't steep enough and wealth management remains a stable contributor to growth. Positive on the sector in aggregate as [profits have returned](#) to pre-crisis levels. Concerned however with individual company risk.

Climbing Back to the Peak

The biggest U.S. banks have almost reached the profit record they set in 2007.

Cumulative 12-month trailing revenue of the ten biggest U.S. banks



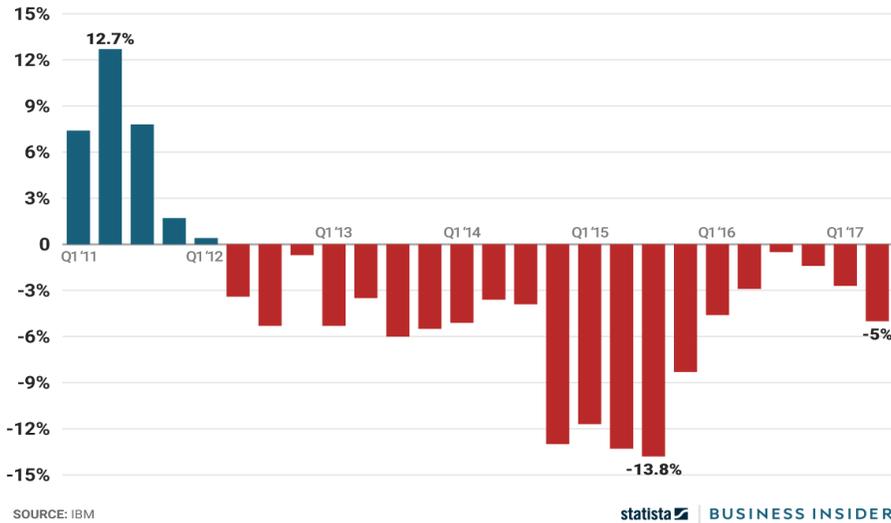
Note: Sum includes the ten U.S. banks with the highest profit in that year.
Source: Data compiled by Bloomberg

Bloomberg

The [cold streak continued](#) for IBM as the company reported it’s twenty first consecutive quarterly decline in revenues. Joining other meg-cap technology companies [Cisco](#), Hewlett-Packard and Intel that are struggling to find growth again in a strong market for technology.

NO END TO IBM'S NEGATIVE STREAK

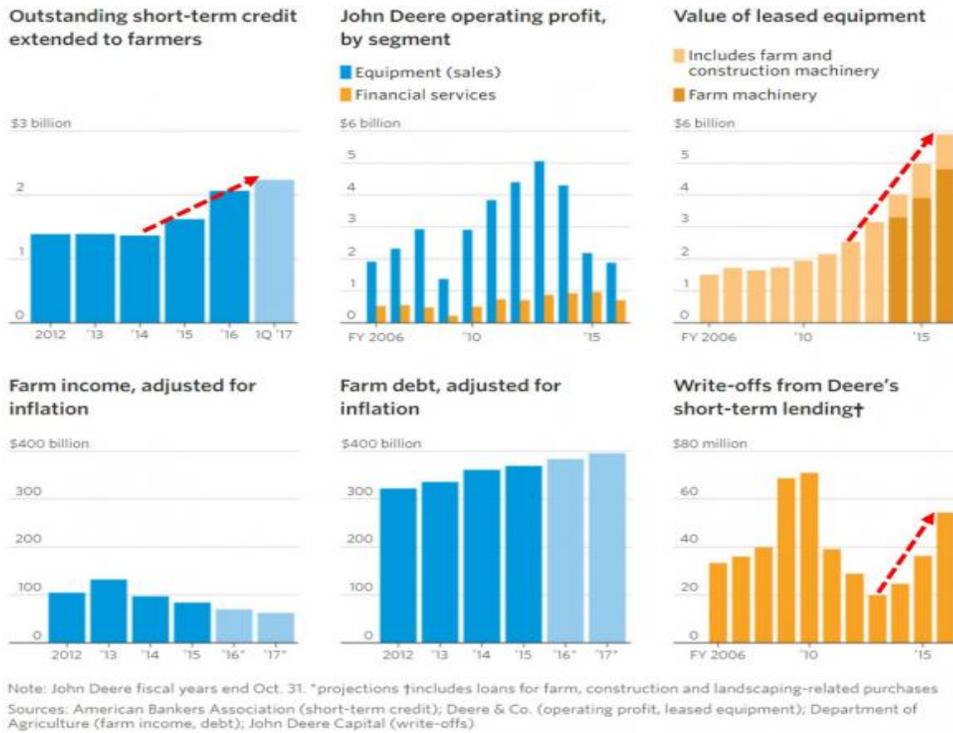
IBM's year-over-year revenue growth rate



Stillwater View: IBM, Cisco and Hewlett-Packard have been profitable places to be short of late as they fit the profile of companies not cheap enough to be considered value but nowhere near the revenue growth that technology investors are getting out of Apple, Amazon and Alphabet.

In what is becoming a weekly, if not daily occurrence, Amazon is both giving and taking away billions of dollars in market capitalization as speculation builds around the company's next move. Last week [Best Buy](#) took it on the chin when it was announced that the Geek Squad had company. This week it was Blue Apron on the receiving end when [Amazon Meal Kit](#) was announced. Walking dead retailer Sears soared 20% on Thursday when the world learned that the new "[Kenmore Smart](#)" line of appliances would be powered by Alexa and sold on [Amazon](#). Home Depot, Lowe's, Best Buy and Whirlpool lost a collective [\\$12.5 billion](#) in market capitalization on the news.

The Wall Street Journal reported that John Deere's [vendor financing](#) arm is becoming a bigger driver to the company's earnings and it's now the fifth largest lender to farmers. Of concern is the rising ratio of financial services revenue to equipment profits and the rise in write-offs in short-term lending



Stillwater View: Vendor financing works well...until it doesn't. If there is growth to support the risk it's a worthwhile, borderline necessary, endeavor. But when the music stops, look out below. Lucent learned this lesson the hard way in the late '90's when they vendor financed billions in equipment sales to support upstart telecom carriers that wanted growth at any price. The bet soured when prices cratered and demand evaporated on the other side of the Internet bubble. Positive view on heavy equipment filter maker Donaldson Incorporated.

Up and Down Wall Street

Bloomberg profiles Trump confidant and real estate maverick [Tom Barrack](#).

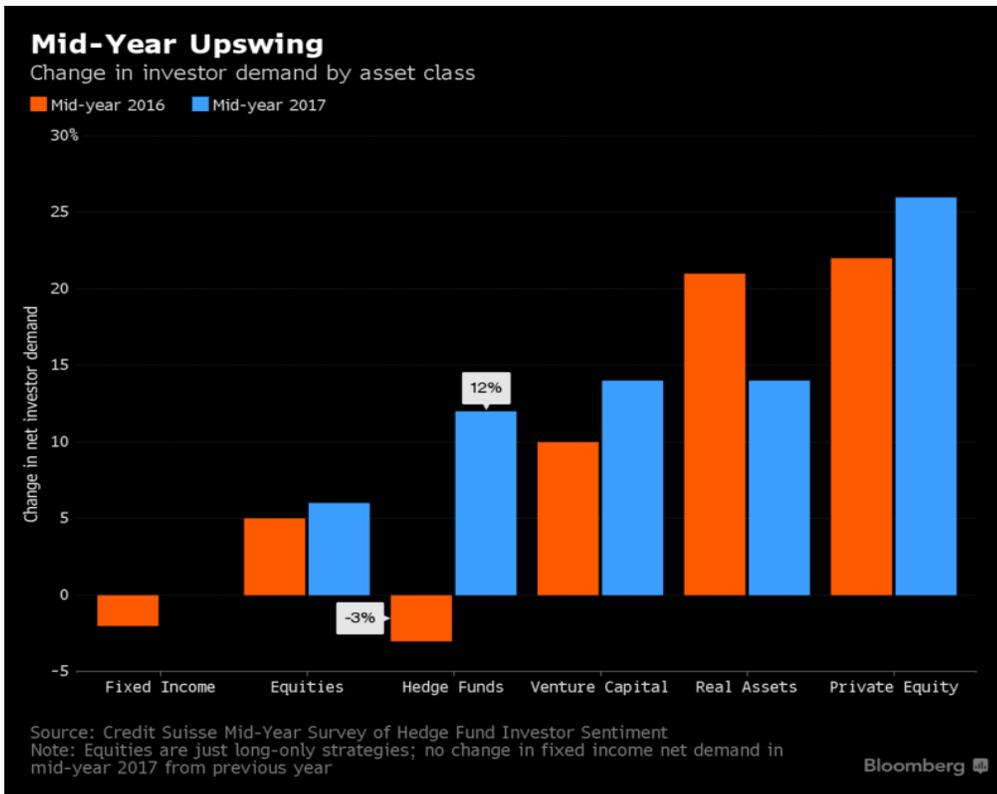
Best wishes to [T. Boone Pickens](#) as he recovers from a fall suffered last week. Please don't shy too far away from the mic, Boone.

Private equity firm KKR & Co. laid the foundation for the [next generation of leadership](#) with the promotion of two partners in their 40s under 73 year old founders Henry Kravis and George Roberts.

Houston based EnerVest's [Fund XIII](#) has lost substantially all \$2 billion of investor money. This vintage 2012 fund invested at the top of the oil market and borrowed heavily to do so. This failure follows the on heels of losses incurred in the firm's Fund XII.

Investment bank Credit Suisse released their annual [Mid-Year Survey of Hedge Fund Investor Sentiment](#) and the results showed [strength in demand](#) for alternative strategies with structures and

fees more properly aligned with investor interest. Bloomberg explains how [stock lending](#) is driving down fees for ETF investors. Perma-bear David Tice shared his view that it's [dangerous to short stocks](#) in the current environment and you should be buying gold.



There is a bull market in bacon as [prices for pork bellies](#) have rallied more than 70% this year on [increased demand](#) and summer seasonality. Bloomberg's Stephen Gandel views the announced IPO of [Bobby's Burger Palace](#) as a [popping of the burger bubble](#). One former In-n-Out employee [revealed the secrets](#) behind the chains magic. And a burger out still beats a cardboard [box on your doorstep](#).

Stillwater View: In-n-Out >>>> Shake Shack...and Blue Apron.

Diversions

Presidents Bill Clinton and George W. Bush shared the stage at the Bush Library in Dallas last week, providing a [moment of political levity](#). David Rubenstein's [interview](#) with two, which begins at the 15-minute mark, will make you yearn for a not so long ago time of kinder and gentler civil discourse.

Play at the British Open, or [The Open](#) as the R&A would [strongly prefer](#) you call it, continues today and through the weekend at Royal Birkdale. Phil Mickelson left his [driver back home](#) and longtime caddy [Bones Mackay in the booth](#). Legendary BBC golf announcer Peter Allis provides us with one

of his [greatest broadcasting](#) moments ever. Son Gary details the family's [four generation](#) connection with the game.

Nestled between I-405 and Bel Air Country Club sits tiny [Moraga Vineyard](#). It punches well above it's 16-acre size with the high-end Moraga Estate Red selling for \$150 a bottle. Current owner Rupert Murdoch gives a [behind the vines](#) look at the operation. North by two hours, [Jalama Canyon Ranch and Vineyard](#) has established a great name for itself with the JCR Pinot Noir. Co-owner and friend [Wayne Siemens](#) explains how it came to be. *The New York Times* explores the "[Unexpected Wine Sanctuary in Baja California](#)".

The Discovery Channel's [Shark Week](#) kicks off on Sunday as Olympian [Michael Phelps](#) takes on the Landlord. It's been great white summer in [Santa Barbara](#) as several juvenile members of the species have decided to call [Padaro Lane](#) home. Chief Brody was right, they were going to need a [bigger boat](#).

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