



The year-end edition of Stillwater Capital's 'This Week in the Markets' brings a compilation of 2017's most interesting subjects. From the serious topics of the day to the irreverent, we covered a lot of ground. Join us in putting a great big bow on the year, albeit a surreal one at times.

We included pieces written on Cryptocurrencies and momentum investing that proved popular. While longer than most, they helped frame two of the more complicated subjects of the day.

Next Friday Stillwater Capital will look ahead to what could keep the global growth bacchanal going in 2018. We will also set the stage for what, or who, might remove the punchbowl. Or at the very least water it down enough so that everyone doesn't get too carried away.

The Top- Down

In June PIMCO went out with the view that investors should stop taking the markets for granted and raise cash on rallies. In their annual Secular Outlook piece entitled Pivot Points, they opined that there is a 70% chance of recession in the next five years and that central banks have not effectively restocked the tool chest to deal with it.

Stillwater View: There is a 100% chance that PIMCO's 70% chance of recession comes true. Every decade since the 1930's has seen at least one recession. They average 8 to 10 month's and are a simply a part of the economic cycle.

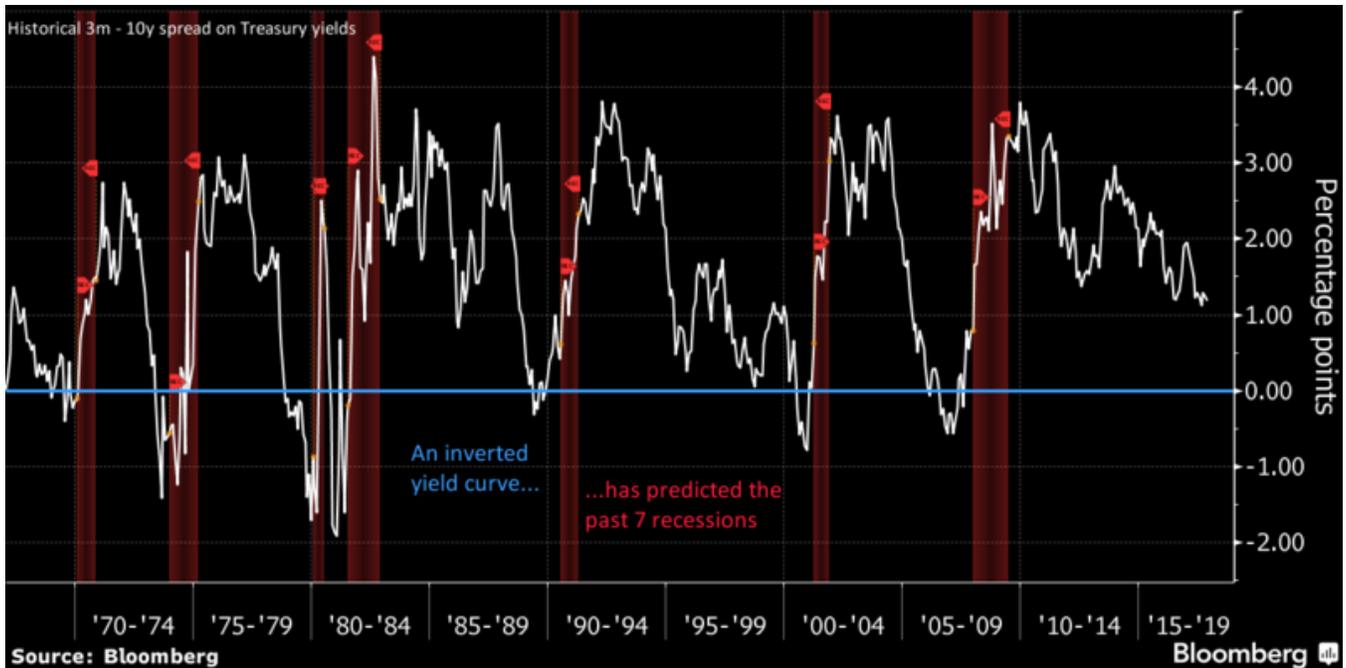
S&P 500 Performance Since 1930 - Recessions in Grey



Source: MacroTrends

The flattening of the yield curve has some thinking that you won't need to wait five years to see the next one. BlackRock's Russ Koesterich explained why it's happening and if the market should be concerned.

An Inverted Yield Curve Preceded the Last Seven Recessions



Source: Bloomberg

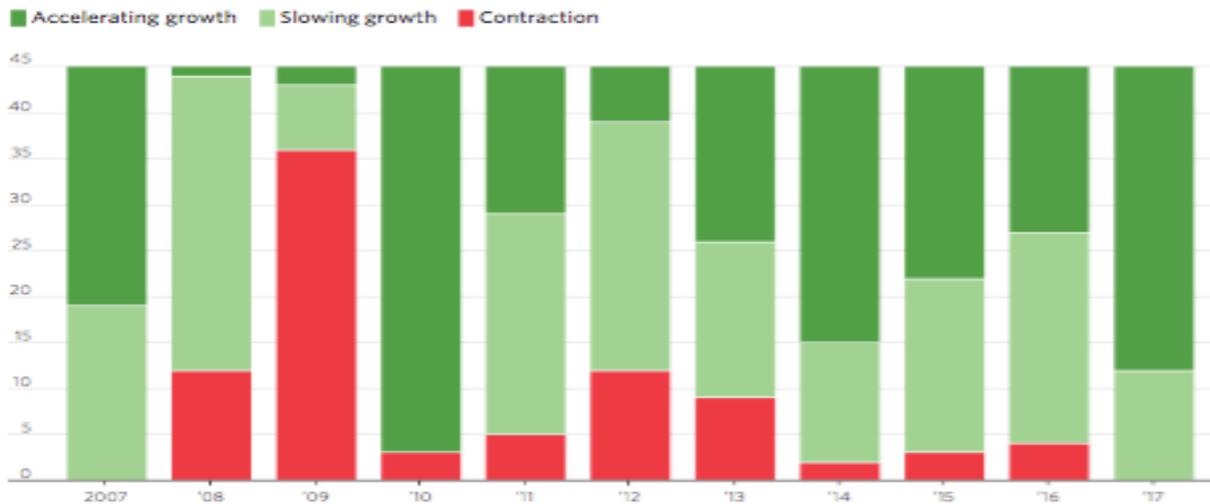
Stillwater View: We have 100 basis points to go before the curve inverts. The equity markets will not respond well when it does. The upshot for those long the market is that it could take a while to get there.

The Fed's annual August gathering in Jackson Hole proved less eventful even though it would be Fed Chair Janet Yellen's last. Kansas City Fed President Esther George provided her view that rates should be heading higher, even with subdued headline inflation.

The Kansas City Fed hosts the annual event. For those with an interest in the history of this gathering of central bankers there is "In Late August". This year the economic backdrop was different and it's the first time in a decade where there was synchronized global growth.

Global Growth Gets the Green Light

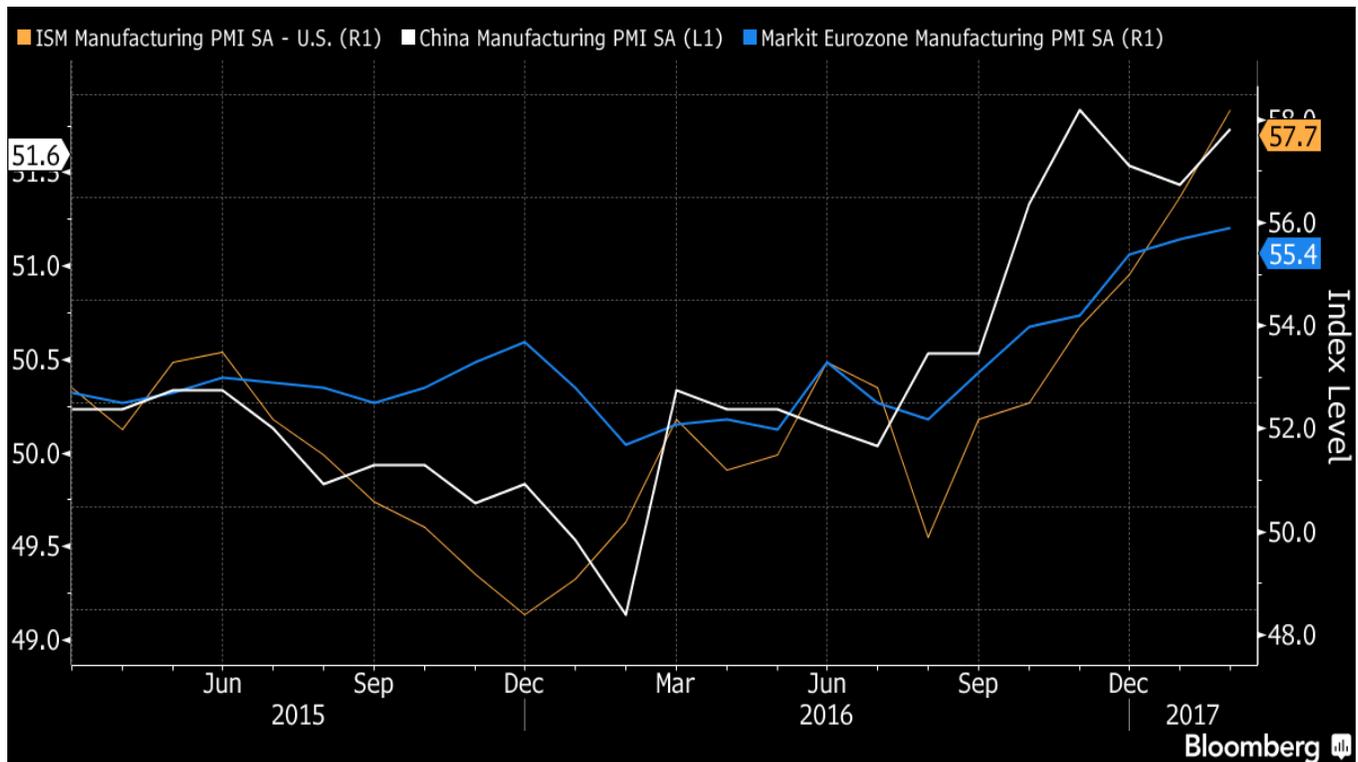
Number of major economies tracked by the OECD with:



Note: 2017 is a forecast based off first and second quarter data for most countries
 Source: Organization for Economic Cooperation and Development

Source: The Wall Street Journal

Global Purchasing Managers Indexes Rise Together



Source: Bloomberg

Stillwater View: Janet Yellen should have held a press conference from a saddle seat in the Million Dollar Cowboy Bar and proclaimed, "I did my job, gave the market QE cover for a 32% rise during

my time here and am completely fine watching how this plays out from the sidelines. Now pass me a cold Moose Drool.

The Million Dollar Cowboy Bar – Jackson, Wyoming



Source: Million Dollar Cowboy Bar

President Reagan's Director of the Office of Management and Budget, David Stockman, made 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 in November of last year.

"This is a bubble created by the Fed," he said again. "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".

The 'Orange Swan'



Stillwater view: Stockman has been beating the drum on his “major correction” trade for more than a year. If he indeed has money behind the call, it hasn’t been much fun. While this doesn’t make him wrong, he certainly was early. David still gets style points for “Orange Swan” though.

The Bottom-Up

Oaktree’s Howard Marks and BlackRock’s Larry Fink made appearances in October. Both cautioned investors that valuations aren’t cheap and they should expect lower returns going forward.

Case-Schiller CAPE P/E Ratio

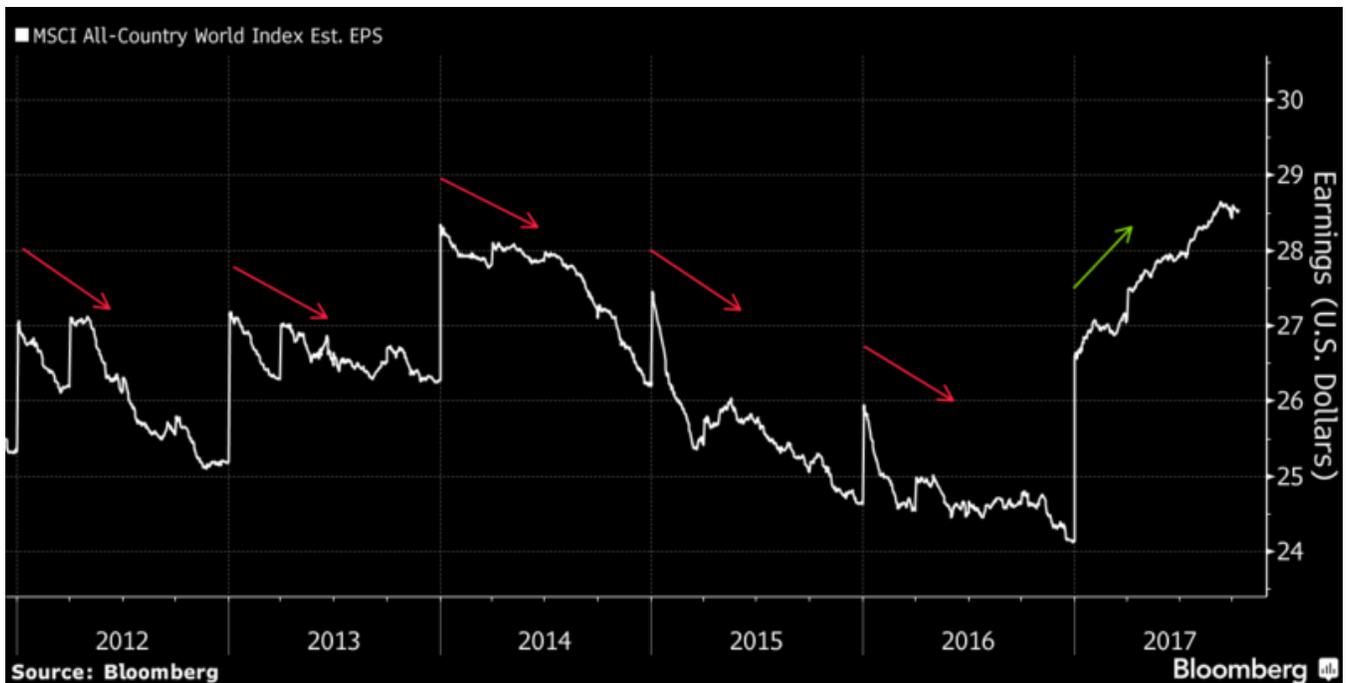


Source: multpl.com

Goldman Sachs strategist [David Kostin](#) went on record in October saying that “There’s no value anywhere in the market. Everything trades at high levels. And everything trades in a well-ordered fashion.”

He added that the market has not discounted the potential impact of tax reform passing and the \$8 it would add to aggregate S&P 500 earnings. Meanwhile, estimates for global growth are on the rise and fears of missing out grow by the day.

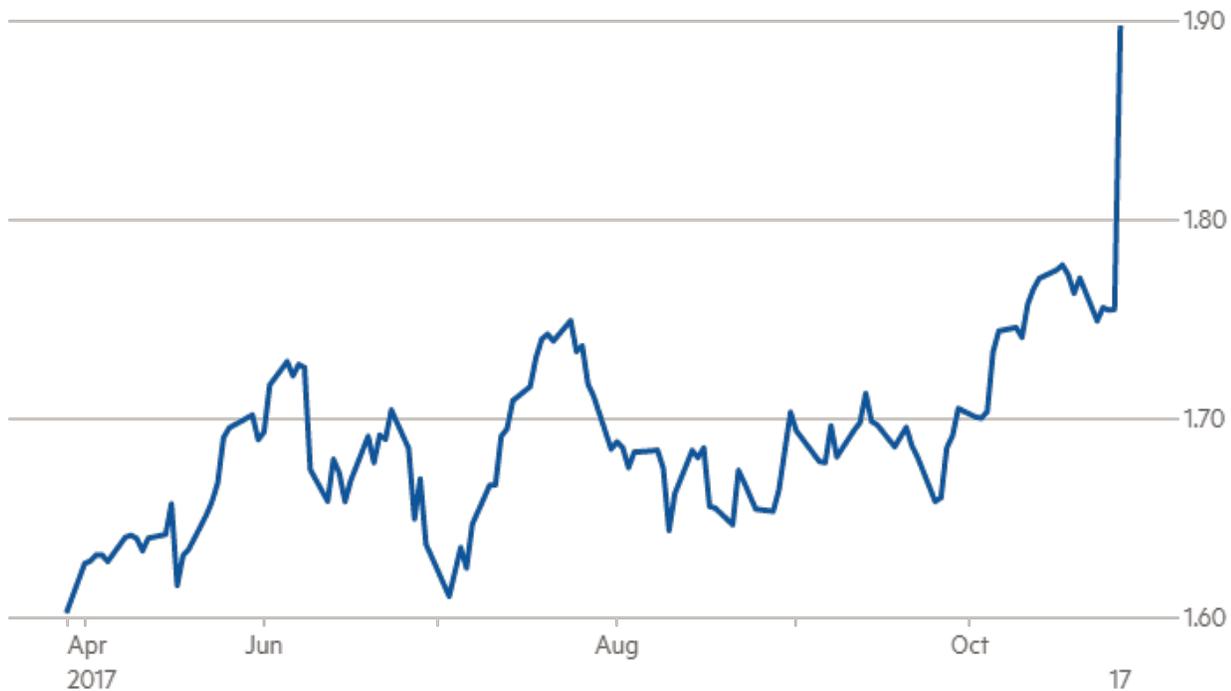
Global Earnings Estimates Rising in 2017



Source: Bloomberg

Friday, November 3rd, was a bellwether day for an already bellwether technology sector when the three horsemen; Alphabet, Amazon and Microsoft, added \$144 billion to their combined market capitalization in a single trading session.

Combined Market Capitalization of Alphabet, Amazon and Microsoft



Source: The Financial Times

To put this in perspective, in a single day GOOG, AMZN & MSFT added one of these to their collective market value.

- 1) IBM
- 2) Pepsi
- 3) Merck
- 4) Disney
- 5) 1.5 Goldman Sachs
- 6) Ford & General Motors with \$44 billion cash left over
- 7) Caterpillar and John Deere with \$22 billion cash left over
- 8) The entire domestic airline sector

Stillwater View: After warming up for the 1988 all-star game three-point contest Larry Bird was feeling it. So much so, that he looked around at the other players including Michael Jordan, Isiah Thomas, and Magic Johnson, and then proceeded to ask, “Now, who’s playing for second?”

Larry ‘The Legend’ Bird



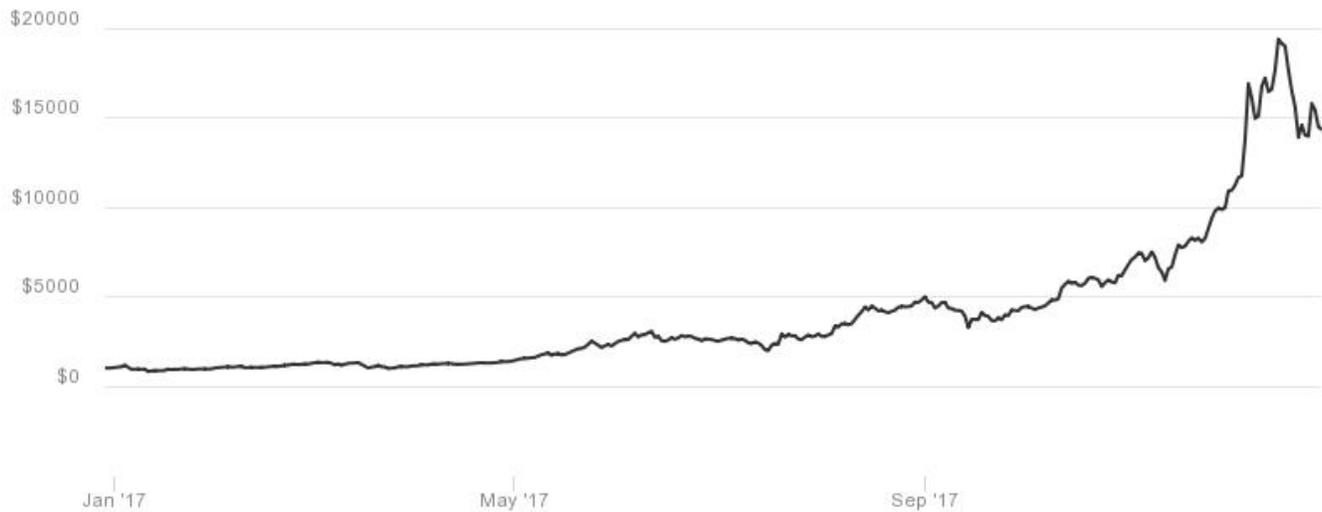
Source: NBA

In today's market, Facebook, Amazon, Apple, Google and Microsoft are 'Larry the Legend'. Those five stocks accounted for half of the 3% rise in the S&P 500 during October. That's right, 1% of the companies in the S&P 500 contributed 50% of the gain last month.

Back in June the New York Times penned a piece entitled "Five Big Tech Stocks Build Market Euphoria, and Jitters". A short five months later the jitters are being felt are by everyone from retail investors to active mutual fund managers who are underweight the stocks. The fear of missing out has fully taken over.

As cryptocurrencies continue to take up a larger amount of the market's bandwidth, some prominent members of the Wall Street community are taking very public shots at it. J.P. Morgan CEO Jamie Dimon called Bitcoin a "fraud" and said that his daughter made some money trading it and now thinks she's a genius. Defenders were quick to call him out, accusing Jamie of defending his banker turf.

Bitcoin Exploded in 2017



Source: Coindesk

Some view the long side of Bitcoin as the most crowded trade in the world. Allianz’s Mohamed El-Erian believes the currency should be valued at half the current price. Former host and current *CNBC* contributor Ron Insana piled on saying that Bitcoin was in a bubble that was guaranteed to crash.

Social Capital’s founder Chamath Palihapitiya and cyber security entrepreneur John McAfee are both on the long side of the trade. The market also handed Mr. Palihapitiya \$600 million and free reign for him to do with it what he wants in a rare “blank check” IPO.

While cryptocurrencies can be conceptually difficult to grasp, Goldman Sachs counseled clients to manage their skepticism appropriately as real dollars are being put to work and the subject deserves proper attention.

For those interested in venturing down the digital rabbit hole Stillwater Capital provides *Crypto 101*. A primer on cryptocurrencies, blockchain and initial coin offerings.

Cryptocurrencies – The name crypto derives itself from cryptography, the process of taking legible information and converting it into secure code. The currency itself is nothing more than an unregulated digital creation that can be used for secure payment or speculation.

Bitcoin, the first cryptocurrency, was introduced in 2009 and has become the largest by market capitalization at roughly \$75 billion. All cryptocurrencies lack a central authority or backing by governments. However, they have the convenience of low transaction costs, anonymity, and no need to open a traditional bank account to send and receive payment.

Stillwater searched high and low for a tutorial that could help advance the cause of understanding cryptocurrency and “Ever wonder how Bitcoin (and other cryptocurrencies) actually work?” is the

best we could find. The spa music in the background certainly helped to create the mental calm necessary to process the explanation of the “cryptographic hash function”.

Cryptocurrency Coins



The increase in the number of coins and the velocity of cryptocurrency transactions is increasing at such a rate that coin farms are cropping up in some unusual places. Like the one profiled by the *New York Times* in Dallad Banner, Mongolia. Owned by Bitmain, this row of low slung industrial buildings is where 5% of the worlds cryptocurrencies are mined.

The World’s Fifth Largest Cryptocurrency Mine



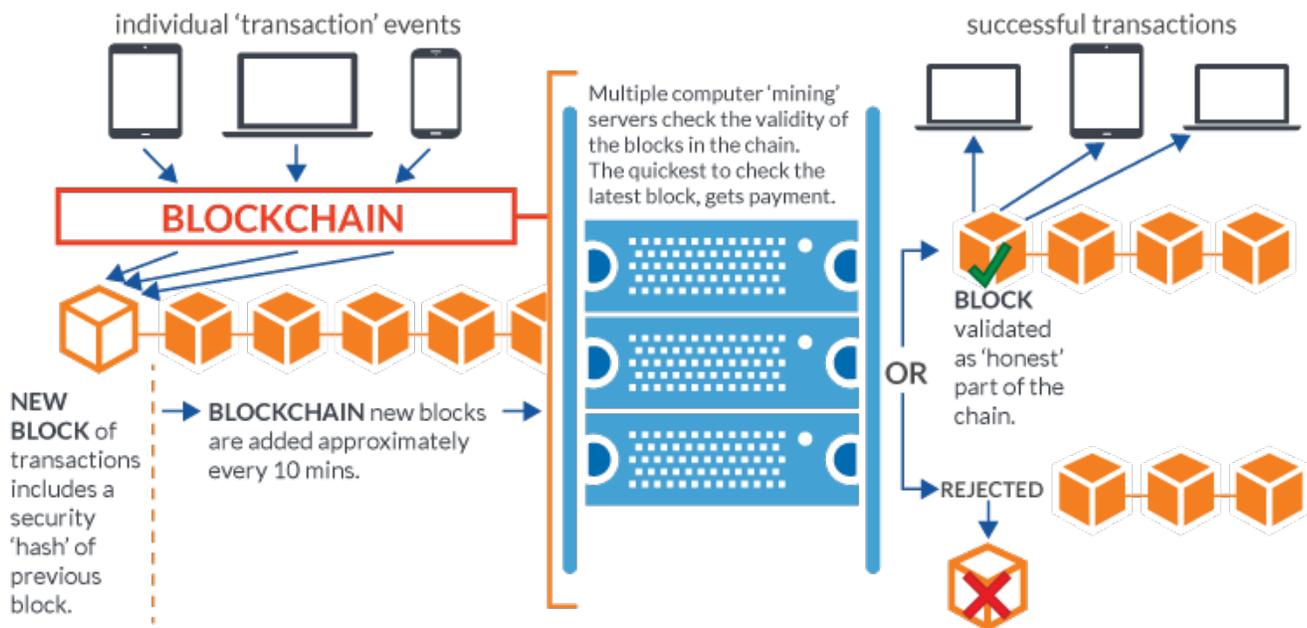
Source: The New York Times

Blockchain – A blockchain is a series of digital records that grows as new transactions, or blocks, are added to the list of previous transactions. A very basic blockchain could show the sales history of a property and would include information like title holder, close date, price, and buyer and seller. This type of series would be easy to validate and require little in the way of processing power due to the limited data points and the long duration between entries.

Blockchains that track, validate and enable crypto currency transactions are the opposite. Here millions of chains of data are validated second by second to ensure the currency has not been corrupted and the transaction history is valid.

The applications for blockchain are vast. So much so that even if cryptocurrencies fade, blockchain will remain relevant, providing transparency to every imaginable transaction series. To paraphrase Jamie Dimon as *Fortune* did, Bitcoin Bad, Blockchain Good.

How the Blockchain Works



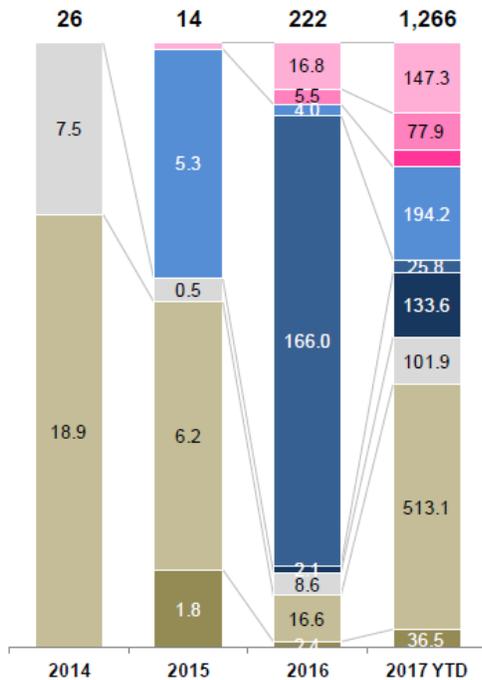
Source: The Wall Street Journal

Initial Coin Offerings – An ICO is similar to crowdfunding and is a way for crypto related companies to issue currency and raise capital. Unlike a traditional initial public offering, the ICO does not require registration or extensive business risk disclosures. Instead, it simply requires a white paper description of the business. And therein lies the risk as described by the highly regarded digital currency observer and professor Andreas Antonopoulos.

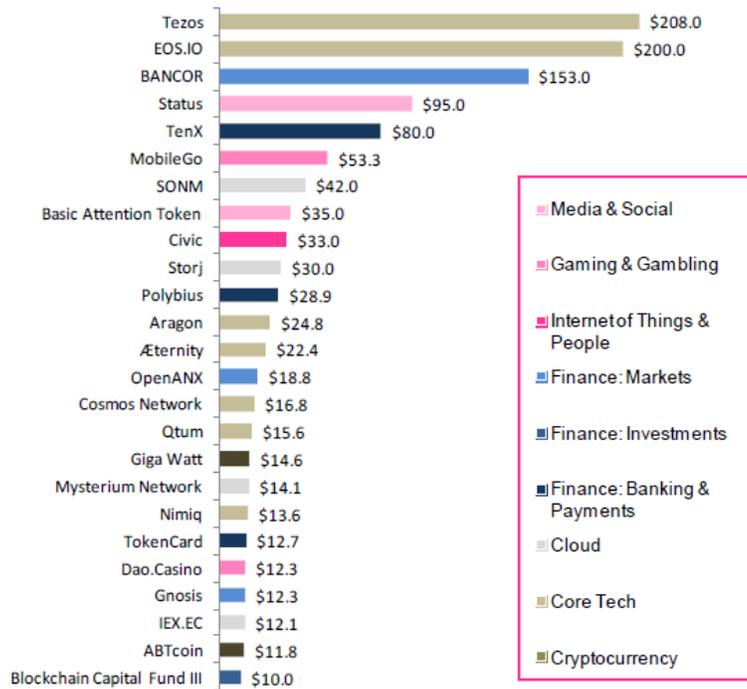
Paris Hilton and boxer Floyd Mayweather are getting in on the act, lending their names to celebrity endorsed ICOs. Attention to the subject ramped up earlier this year when Chinese authorities banned the practice and our own SEC is getting more vocal in their attempt to warn investors of the risk.

Autonomous NEXT research Analysis of the \$1.25 billion Raised via ICO Through August

ICOs by Category (\$ millions)



Top 2017 ICOs by Category (\$ millions)



Source: Autonomous NEXT analysis

Source: Autonomous NEXT

Stillwater View: As Goldman Sachs pointed out, ignore the subject of cryptocurrencies and blockchain at your own risk. Keeping in mind that the former may be this decade's signature bubble moment and the latter is real and has vast applications. Blockchain will be the focus of countless white papers and most certainly a new crop of freshly minted startups looking to be the next "Google/Uber/Facebook/Netflix of blockchain".

Up & Down Wall street

The highly-anticipated book by Ray Dalio, "Principles: Life & Work", was published earlier in the year. Andrew Ross Sorkin writes the preview for the *New York Times*. Mr. Dalio is the founder and CEO of Bridgewater, the world's largest hedge fund. His "How the Economy Works in 30 Minutes" has been watched more than four million times.

He provided his view of the power of radical transparency earlier this year in a Ted talk geared towards the book's release. Ray's first stock purchase was Northeast Airlines with money he earned as a caddy earning \$5.00 a bag.

Stillwater View: The look inside the post-election strategy session at Bridgewater is a fascinating view for anyone who has ever wondered what the beautiful transparency machine looks like. The

video of Ray Dalio on Wall Street Week circa 1982 is priceless, as is his retrospective acknowledgement of arrogance.

Principles by Ray Dalio



Tail-risk funds, those designed to profit from Black Swan events continue to disappoint as market dislocations failed to materialize. The *Wall Street Journal* reports that the strategies are down 6.5% through mid-year. Man Group's AHL Tail Protect fund has lost 45% since inception in 2009.

Black Swan Down

Cumulative return of tail-risk funds since December 2007



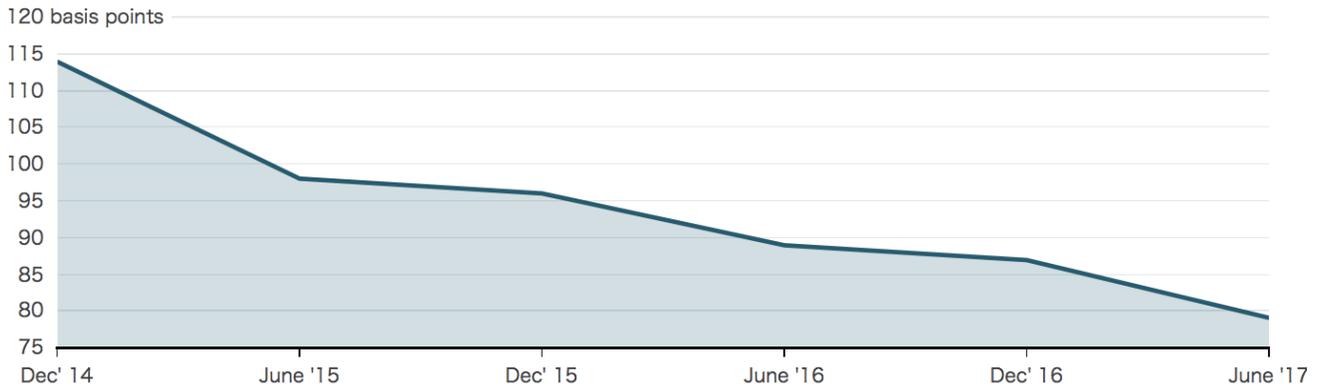
Source: CBOE Eurekahedge Tail Risk Hedge Fund Index

Source: The Wall Street Journal

Like the Swallows to Capistrano, Wall Street pros once again embarked on their annual pilgrimage in search of stable employment, better compensation and greater career satisfaction. The news from Pine River isn't inspiring.

Europe's largest alternative asset manager, Man Group, highlighted the tough reality in the firm's mid-year earnings report. Management fees have compressed 30% in a less than three years.

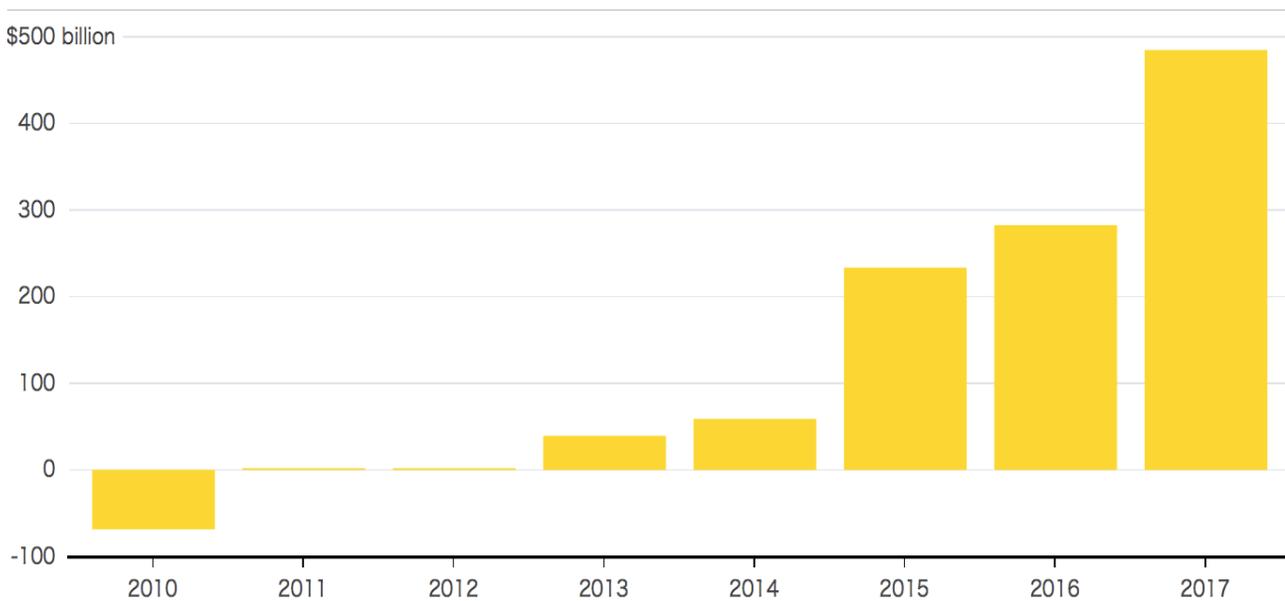
Man Group's Net Management Fee



Source: Man Group

Assets continue to flow from active into passive at a breakneck pace. *Bloomberg's* Mark Gilbert reports the news in "[Devouring Capitalism.](#)"

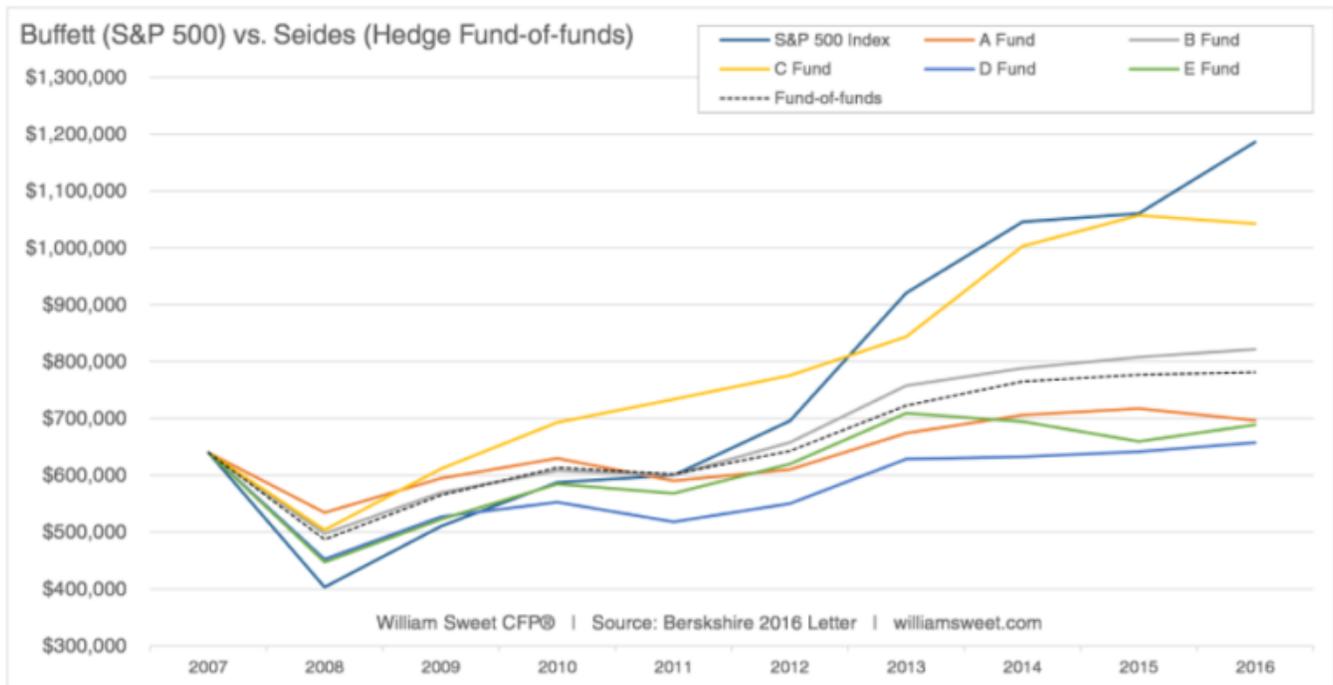
Net Inflows into Passively Managed Through Mid-Year



Source: Bloomberg

[Warren Buffett](#) 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?

S&P 500 vs Seides' Hedge Fund Portfolio



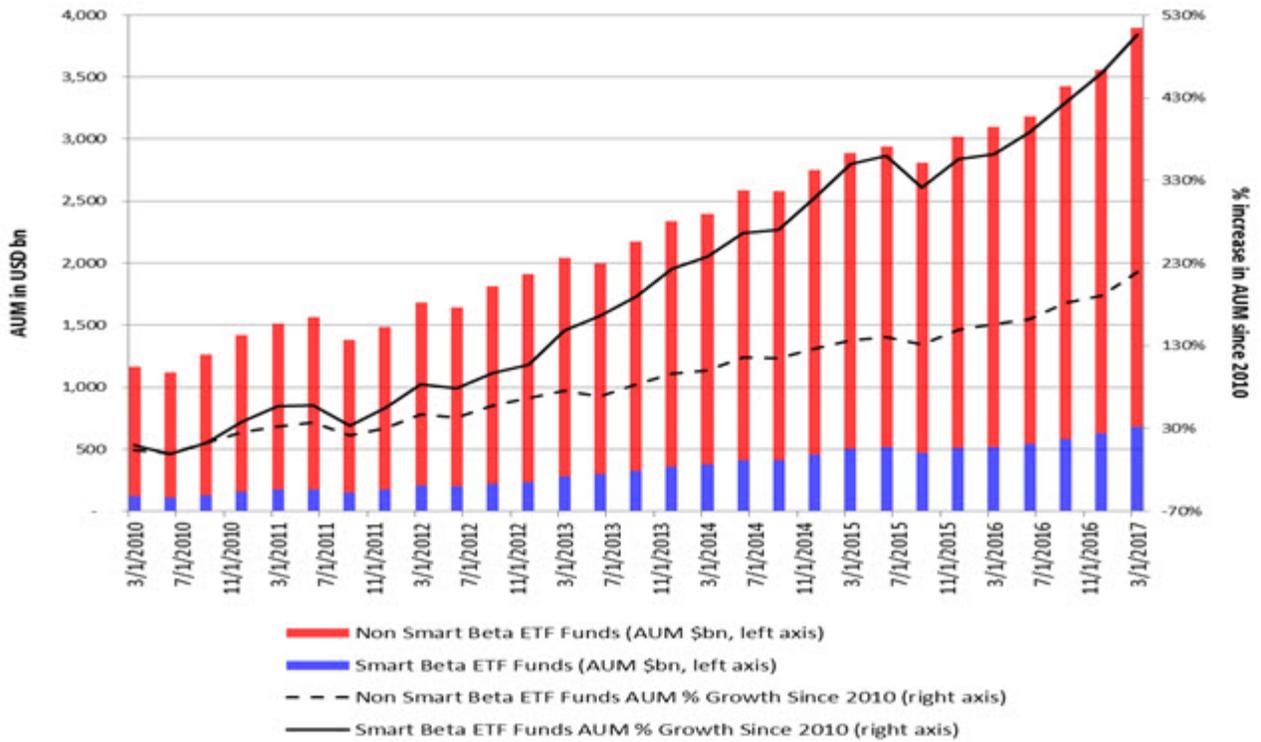
Source: Barclays

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.

Stillwater cleared the 'Up and Down Wall Street' decks to take on AQR Capital founder Cliff Anness and his work on the momentum factor in investing, and the application of it into AQR funds.

By way of background, Cliff was a student of Nobel Prize Winning economist Gene Fama at the University of Chicago. Gene, and his partner at Princeton, Ken French, did pioneering research on factor based investing. The Fama/French 5 Factor model was the foundation from which Smart Beta was built. Rob Arnott, founder of Research Affiliates, wrote a thoughtful piece last year analyzing "How Can 'Smart Beta' Go Horribly Wrong".

Growth in Traditional and Smart Beta ETFs



Source: Wells Fargo “[Quantitative Investing and the Rise of Smart Beta](#)”

Momentum investing is exactly what it sounds like, on the long side it’s buying stocks that have shown a pattern of appreciation, and on the short side, a pattern of depreciation. But like everything, it’s not that simple.

In September 2014, AQR published a seminal paper for the *Journal of Portfolio Management* entitled “[Fact, Fiction and Momentum Investing.](#)” In it they refute certain myths, such as the data doesn’t go back far enough, and that it’s really only a game of ‘hot potato’. Momentum as a factor works. And as evidenced below, works well.

The Outperformance of ‘Winners’ vs. ‘Losers’ in the Market



Source: BlackRock

Cliff appeared at George Mason in 2015 to explain, among other things, momentum as a factor. The ‘rather insane’ proposition is that you buy a basket of stocks that have been going up for the past 12 to 18 months and they will continue to do so. He also appeared at the University of Missouri to present “A Brief and Biased Survey of Quantitative Investing”.

Stillwater View: Most of Wall Street is out searching for answers to the markets unrelenting strength that is lacking both fear and volatility. One of the likely causes is the insatiable appetite for emotionless ETFs that are devoid of the qualitative human factor.

Momentum is probably one of the most interesting quant factors because few on the fundamental side can come close to replicating it. If assets keep flowing into funds of this variety, buying pressure on ‘what’s working’ will continue. Until of course it doesn’t.

While E. Coyote



Source: Geek.com

Diversions

Summer reading, *Shoe Dog, a Memoir by the creator of Nike* with a great interview with Phil Knight as he appeared on The David Rubenstein Show. When asked why the company got out of the golf business he answered “It’s a fairly simple equation, that we lost money for 20 years on equipment and balls. We realized next year wasn’t going to be any different.”

Phil Knight in the Early Nike Days



Source: Runners World

Chef Anthony Bourdain did everyone with a passion for the culinary arts a favor when he produced “The Last Magnificent”, a documentary on the rise, disappearance, and reemergence of the legendary Jeremiah Tower.

Mr. Tower worked under Alice Waters at Chez Panisse and would go on to found San Francisco’s top grossing Stars restaurant. Anthony and Jeremiah appeared with NPR’s Lynn Neary to discuss the film.

The Last Magnificent



Source: The Last Magnificent

In a world where headlines are often too tough to read, it was uplifting to come across one that wasn't. 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 there for 20 years, and the tale of how he got to his post 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



Source: The Los Angeles Times

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