Stillwater Capital - This Week in the Markets

This Week in the Markets is coming to you this morning as a special Sunday Edition. Please enjoy all the news and notes worth reading from last week as well as a recap of Q2. We are also sending our *Diversions* readers, you know who you are, off into Fourth of July week with a very special segment on how to “de-risk” your holiday barbecue.

We are going to go a little long this week as there is a lot out there in the markets to cover and digest. After which we will be getting ready to celebrate the birth of our nation and then go off the grid, literally.

Following a truly all-American 4th of July at the Home of Champions Rodeo in Red Lodge, Montana the author and editor is going to slip off into the backcountry and see if I can get a few Yellowstone Cutthroats to cooperate with my fly line.

In the meantime, enjoy the Fourth of July and we will see you back here in two weeks.

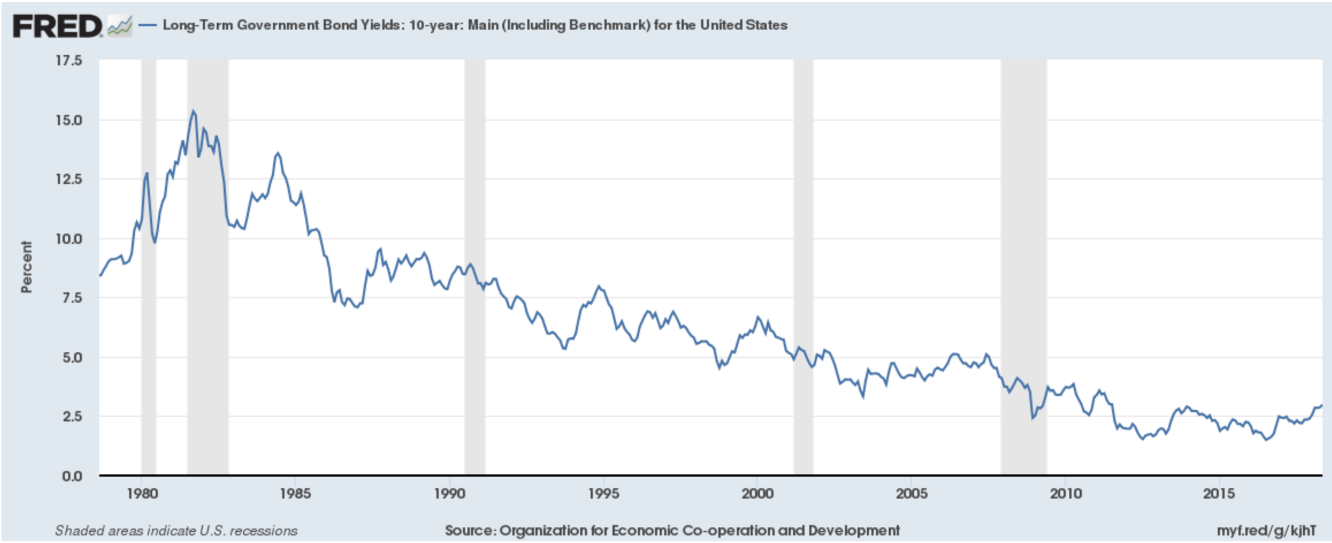
The Home Of Champions Rodeo

Source: Visit Yellowstone

Second Quarter 2018 Market Recap

After some serious early 2018 fireworks, the markets have settled into what most would consider a pretty pedestrian year. Interest rates have shown an upward bias, breaching the 3.0% line on the 10-year but showing little interest in heading higher…for now.

The 36-Year Bond Bull Market



Source: St. Louis Federal Reserve

Stillwater View: Rates may very well have peaked out for 2018 as Morgan Stanley suggests. But we think they are headed higher for a whole lot of inflation related reasons. When they do it will likely put a lid on the markets upward movement.

Meanwhile the yield curve continues to flatten and is on a path to inversion sometime out on the horizon. The current 2 to 10 year spread is a narrow 33 basis points. Which is 21 basis points less than the 54 it read on January 1st.

Two-Year to Ten-Year Spread

Source: St. Louis Federal Reserve

As history has told us, an inversion is not a pending recession's immediate calling card. On the contrary. The time from inversion to recession has averaged 17 months over the past 40 years.

Inversion to Recession Lag Time

Start of Inverted Yield Curve	Start of Recession	Lag Time (Months)
Aug. 1978	Jan. 1980	17
Sept. 1980	July 1981	10
Dec. 1988	July 1990	19
Feb. 2000	March 2001	13
Dec. 2005	Dec. 2007	24

Source: Bloomberg

Stillwater View: The curve is indeed headed towards inversion and will be a factor when we enter our next recession. The evidence suggests it will be a ways off when it does and there will still be some solid late cycle gains to be had, having averaged 16% in the past five instances, well above the average 10% return the broad market has produced for the past century.

Don't Fear the Inversion

Start of Inverted Yield Curve	Start of Recession	S&P 500 Returns
Aug. 1978	Jan. 1980	22.9%
Sept. 1980	July 1981	11.5%
Dec. 1988	July 1990	37.6%
Feb. 2000	March 2001	-15.6%
Dec. 2005	Dec. 2007	22.2%

Source: Bloomberg

With yields out of the way, let's turn our attention to equities. The S&P is showing a modest gain of 1.67% and the Dow is down1.8% on the year. Small and mid-caps have outperformed large multi-nationals on the back of trade war concerns and questions around growth in Europe and emerging markets.

The good…Technology, technology and more technology. But it resides once again in the five horsemen of the market: Facebook, Apple, Amazon, Netflix and Google. Those that remember the Nifty Fifty days of yore are calling this the return of that period when market leadership became very narrow. They also point out that it didn't end well.

The Nifty Fifty Bear Market = Down 45%

Source: The Palm Beach Daily & Y Charts

Stillwater View: As the hip kids like to say, "don't hate the player, hate the game". This is where Stillwater currently stands on the FAANGs.

Facebook = Short the stock at lower levels on concerns that data privacy and the Delete Facebook movement eventually impacts user growth.

Apple = Long at lower levels as the company is simply a cash generating machine that continues to grow an ecosystem that once you get in, you can't get out. Very willingly in fact.

Amazon = Long at lower levels as the company continues to advance at will. Taking on industry after industry. And doing so successfully. See below for the damage inflicted on the pharmaceutical distribution business last week. The price appreciation has been so strong that the position is bumping up against our 10% maximum holding rule. It's a good problem to have.

Netflix = Long at prices we are borderline embarrassed by. And not in the way we like to be. But much like Amazon, they are taking on the media industry and turning it on its head along the way. Biggest concern is the lack of free cash flow.

Google = No position. While you can own them all, we simply don't. And not for any really good reason except that we understand the business models of the others much better.

Facebook, Apple, Amazon, Netflix, and Google

Source: Hedgeye

Onward for a quick whip around the rest of the various sectors and sub-sectors of the market through the first half of the year.

The Good…the aforementioned technology sector followed by consumer discretionary, rounded out by energy. Most all of this makes sense in the latter stages of an economic expansion. The market loves the earnings growth in tech, the high level of consumer confidence and low unemployment, and demand pull for petroleum has the sector working as well.

S&P 500, Energy, Technology, Consumer Discretionary

Source: Nasdaq

The Bad…Financials, Health Care and Industrials. Financials have been a bit of an enigma here. They led strongly in the first quarter and have given it all back. Tough to know if this is related to curve flattening or end of cycle fears. Health care is…well health care. This is the one sector that befuddles us as there are cross currents across so many sub sectors. Finally there is the industrial sector, stalling out on fears of a trade war and the impact this will have on revenue generated overseas. Defense has been hit particularly hard, falling off a cliff over the past two months.

S&P 500, Financials, Health Care, Industrials

Source: Nasdaq

The Ugly…Telecom and Consumer Staples. Telecom is on its tail due to an ongoing price war where rates are headed down and service is headed higher. Consumer Staples face the dual headwind of higher interest rates stripping away their bond equivalence appeal, pricing pressure, and a lack of fear in the market that make these stocks appealing in a time of stress.

S&P 500, Consumer Staples, Telecommunications

Source: Nasdaq

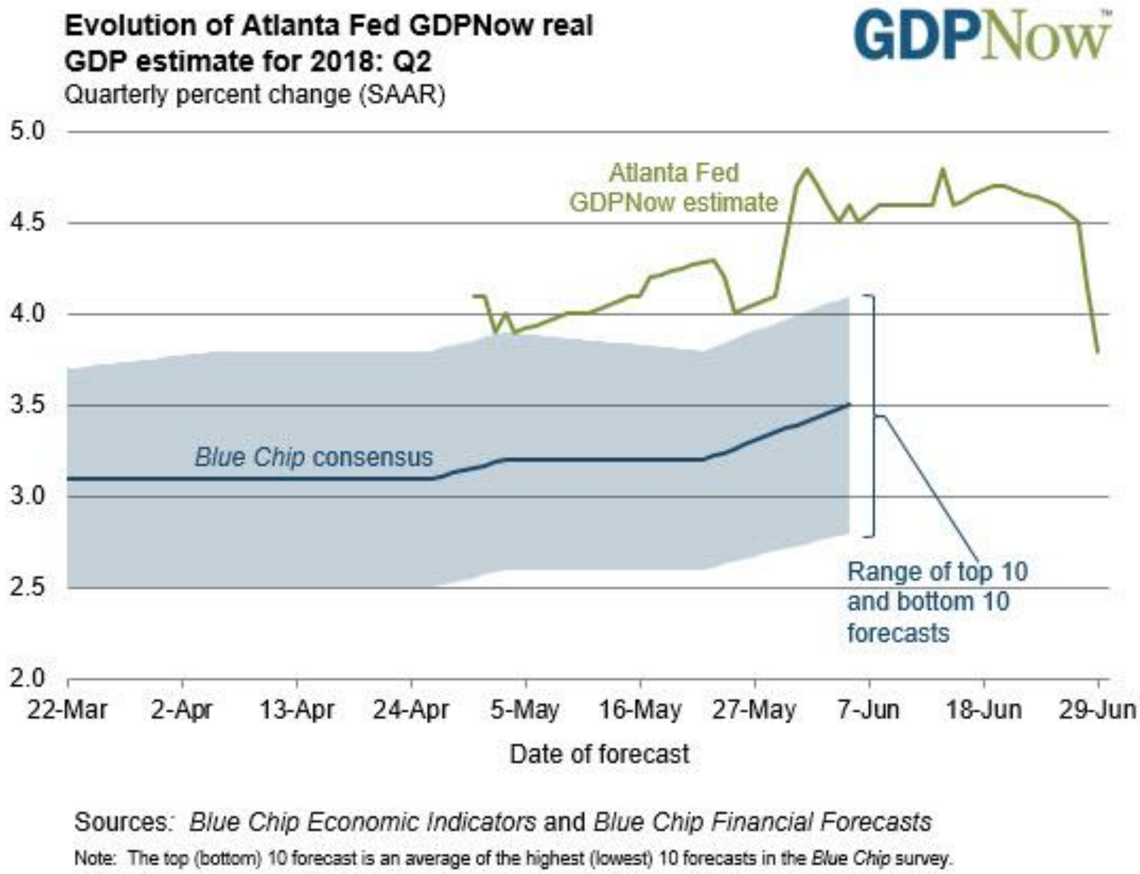
Stillwater View: With some pretty strong macro tailwinds in place its tough to see how the leaders and laggards change much in the near term. Biggest swing factor is if the trade war threat goes from the cold kind or becomes one where real bullets start flying. The other swing factor is rates. If they back off look for staples, utilities and telecommunication to pick up the pace.

The Top- Down

It was a quite week from the top-down. On Friday we got the final Q1 GDP revision and growth slowed from a 2.9% clip in Q4 of 2017 to 2% in the first. Weak consumer spending was blamed for the downgrade from the previously reported 2.2%.

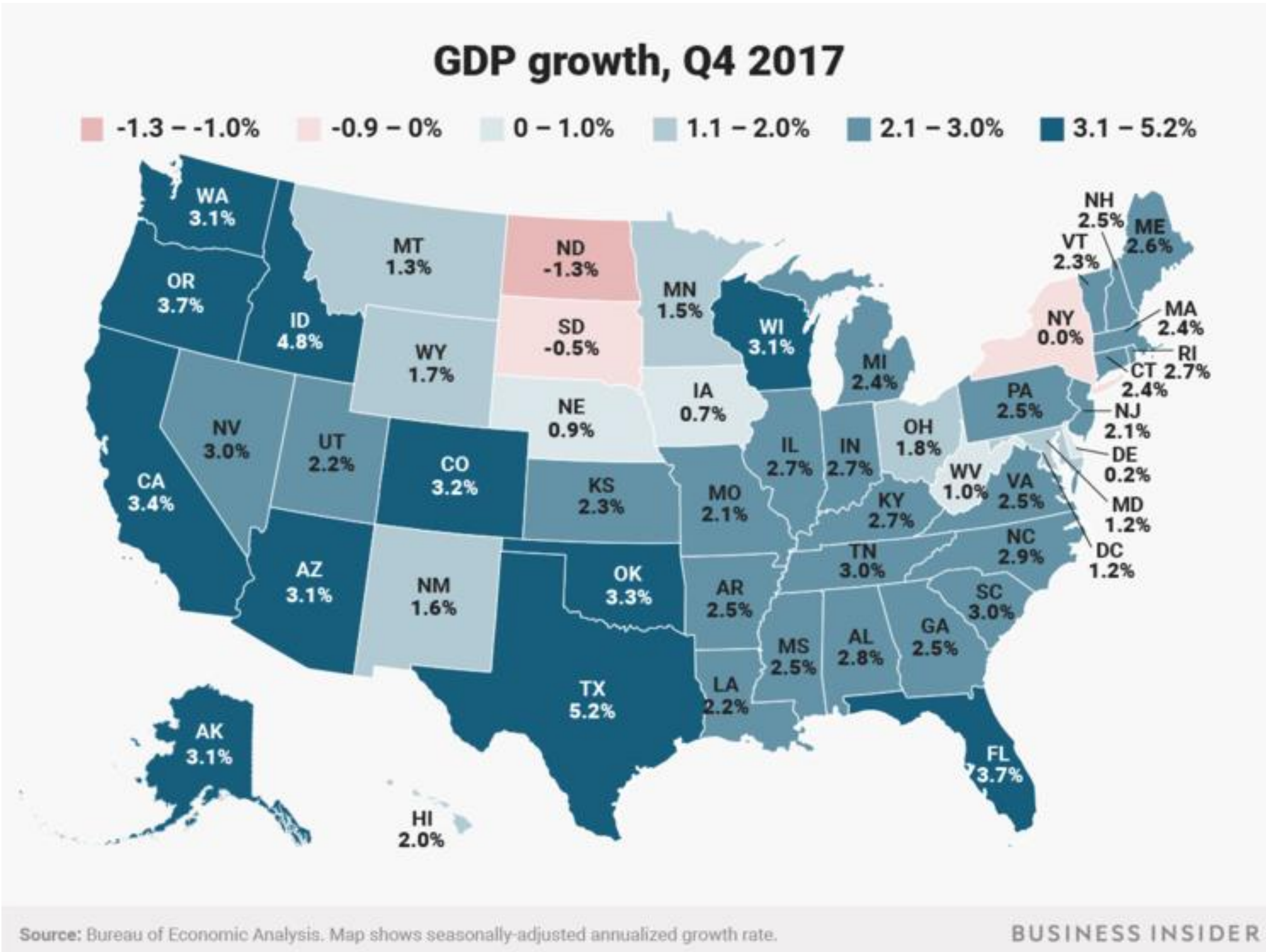
The highly followed Atlanta Fed GDPNow forecast took a nosedive as well this week. Dropping from a projected gain of 4.5% in Q2 to 3.8%. Still robust growth, but far less than anticipated. The culprit? You guessed it, perceived weakness in consumer spending. Which does not jive with what the market is saying

The Atlanta Fed's GDPNow



Business Insider has a great series of charts showing the growth and unemployment picture across the 50 states. The data series is from Q4 of 2017, but it gives you a good idea and an even better image of how things are looking from coast to coast.

GDP Growth Across All 50 States



Source: Business Insider

As we are taking the holiday shortened week off , we want to give you a preview of Fridays employment report. While *Bloomberg* provides a broader look at the week ahead.

What more can we say but the employment trend is very much our friend right now, boosting the market every month so far in 2018. Same chart from last week showing a familiar pattern that has emerged around the start of every month.

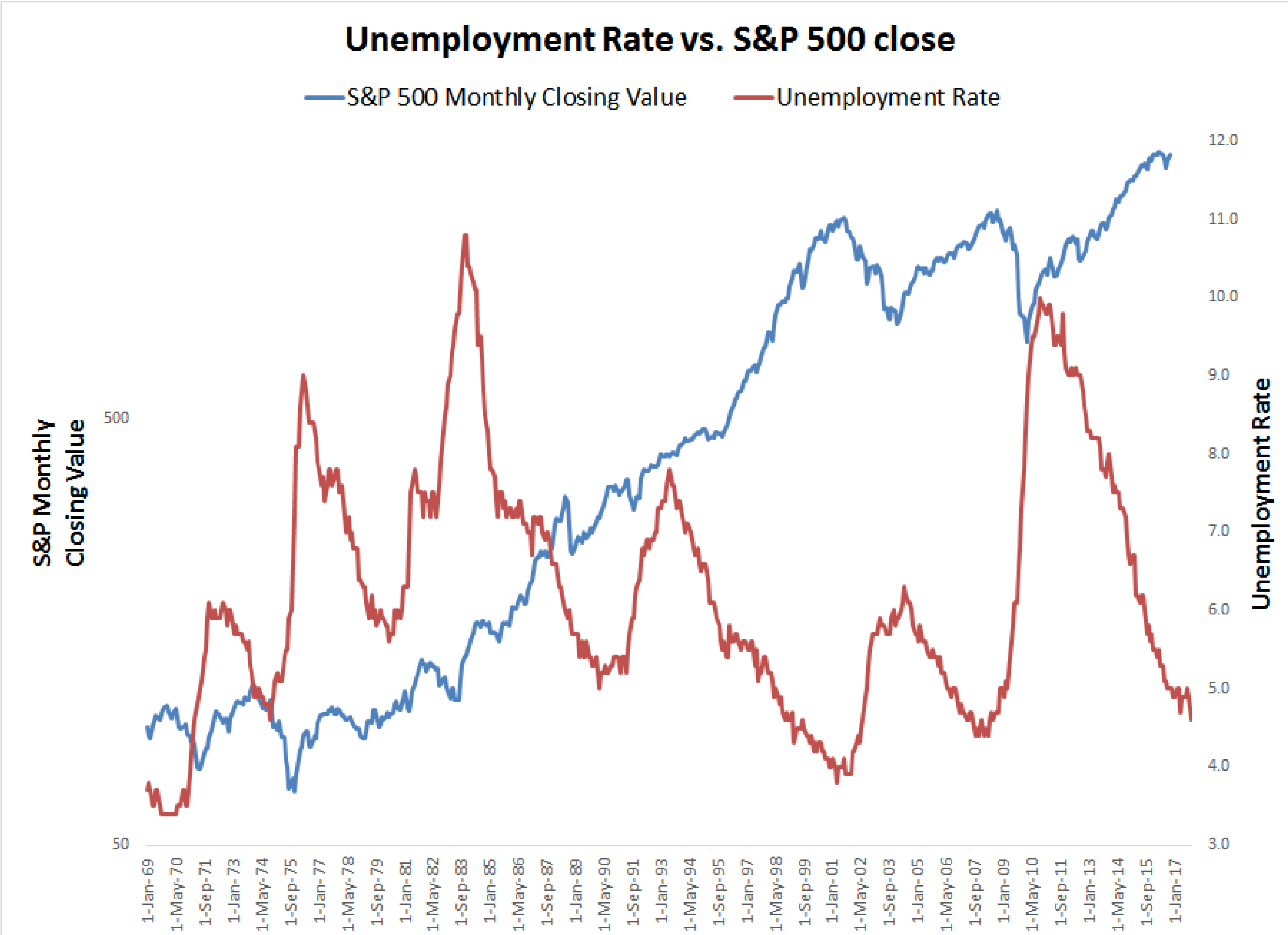
Poised to Move Higher…Again?

Source: Nasdaq

Stillwater View: Any print that starts with a 2 handle and we are head higher. Between 100k and 200k we are still good. A number that is sub that and watch out for an air pocket. If and when this series changes direction, look out for some serious market weakness and rotation. In the meantime, the 200 day moving average on the S&P 500 provides support.

While the chart below is dated to 2017, it does however show the longer term relationship between unemployment and the equity markets.

Unemployment Rate vs. S&P 500

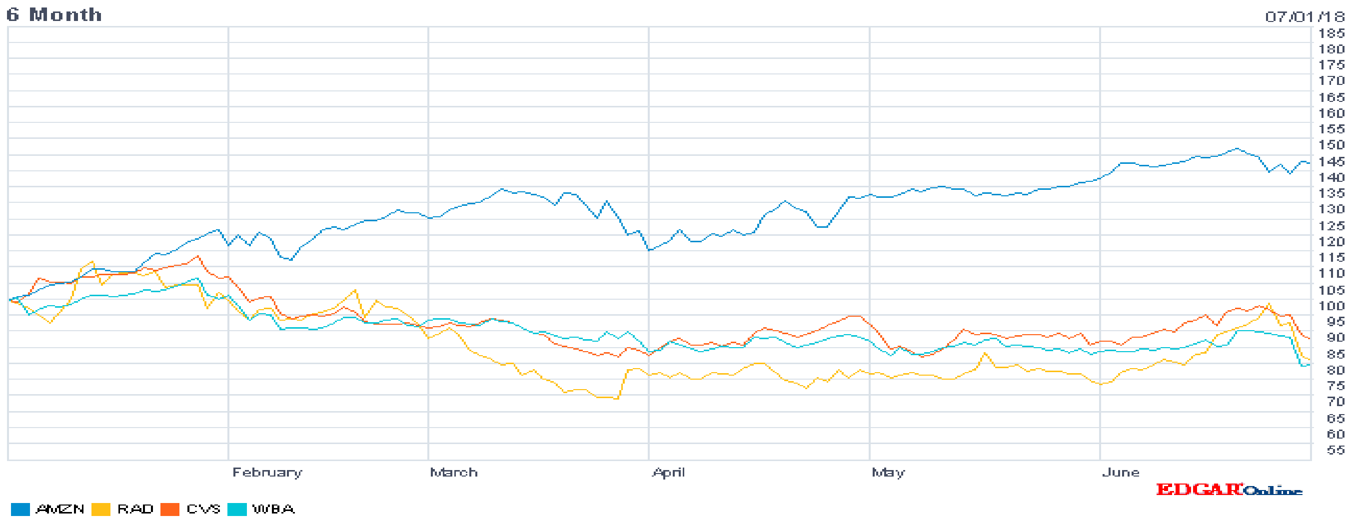


Source: Seeking Alpha

The Bottom-Up

Jeff Bezos turned Amazon's super laser on the pharmacy distribution business this week when they agreed to purchase PillPack for an undisclosed amount. The move sent CVS, Walgreens, and Rite-Aid into a tailspin on Thursday as they collectively lost $12 billion in market capitalization while Amazon gained $18 billion. Business Insider added their thoughts and analysis.

Amazon vs. Rite-Aid, CVS, Walgreens



Source: Nasdaq

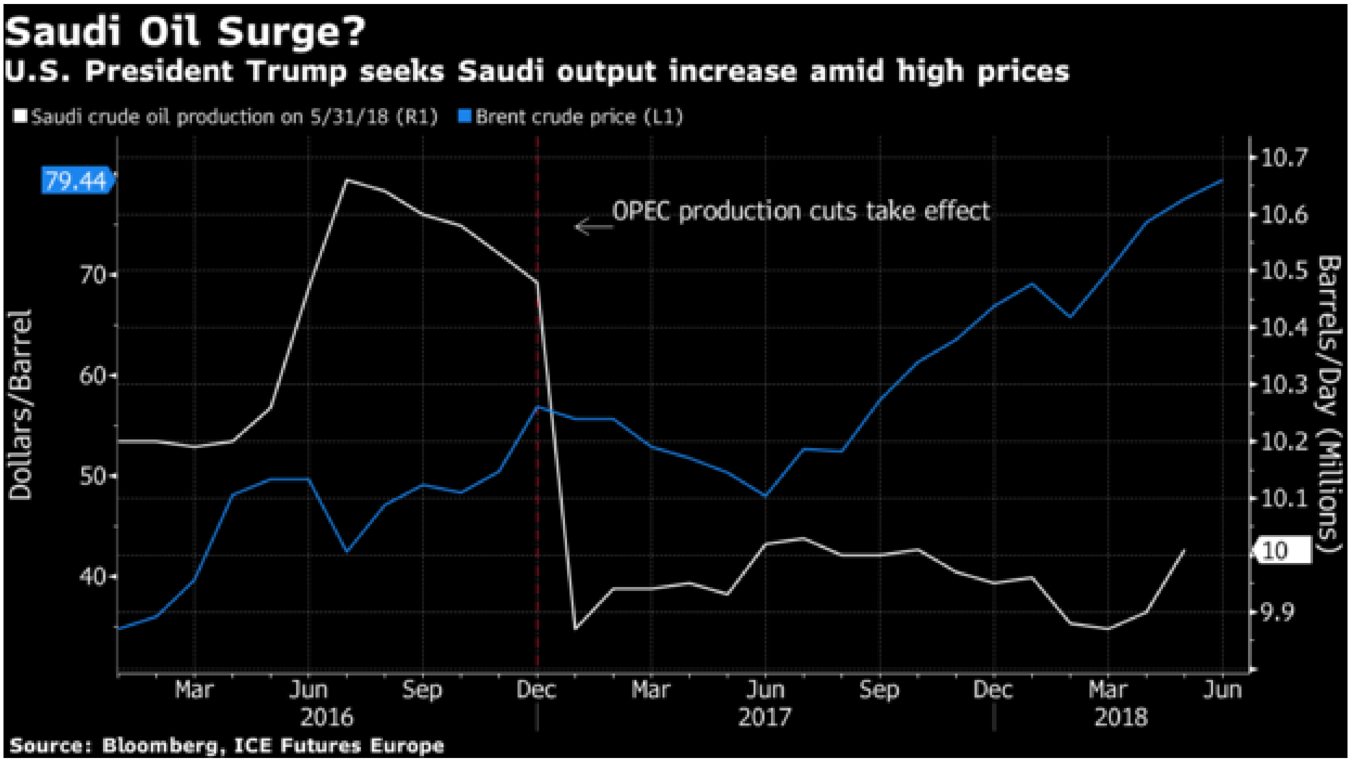
Stillwater View: Looks like a pretty perfect pair trade to us.

The oil patch is once again heating up, so much so that President Trump has entered the market by negotiating with Saudi Arabia to open up the spigots and take production up by 2 million barrels to their full 12 million daily capacity. Here is the text of Trump's tweet on Saturday.

"Just spoke to King Salman of Saudi Arabia and explained to him that, because of the turmoil & disfunction in Iran and Venezuela, I am asking that Saudi Arabia increase oil production, maybe up to 2,000,000 barrels, to make up the difference...Prices to (sic) high! He has agreed!,"

And in true Trumpian form, the assertion that a deal was struck was put to rest hours later. Turns out Saudi Arabia confirmed it *had* 2 million barrels of spare capacity that it *would* "prudently use" it. In the meantime the Kingdom is enjoying the benefits of mid-$70 crude oil.

Making It Up on Price, Not Volume



Source: Bloomberg

The re-imagination of General Electric continued last week as the company announced the spinoff of its healthcare business into a standalone company, with a standalone dividend. A move that the market applauded and had J.P Morgan analyst Stephen Tusa saying would lead to a "precipitous" cut of 30% to the payout in 2019. The current yield is roughly 3.50%.

Activist Nelson Peltz continues to advocate for the breakup of this once proud conglomerate. The *Cincinnati Enquirer* provides a look at what that might look like.

Where GE Plays

Source: General Electric

Up & Down Wall Street

David Einhorn cannot get out of his own way in 2018. His Greenlight Capital hedge fund is down 18% on the year through June, dropping another 7.7% last month. Big bets on General Motors and against Tesla have hurt performance.

The word "surprised" can't really begin to tell the story of how bad the situation is. This market is not giving up the kind of 20% plus gain Einhorn needs to see to get back to even and start collecting a performance fee.

Einhorn Rolling Snake Eyes in 2018

Source: Poker News

A couple of guys in our business are doing things right. This week *Bloomberg* profiled Soren Aandahl, the founder and portfolio manager at Blue Orca. His short selling of international stocks has been working, and working well of late. The story highlights his move out of "zeros" and into larger and more well-known names like Samsonite International.

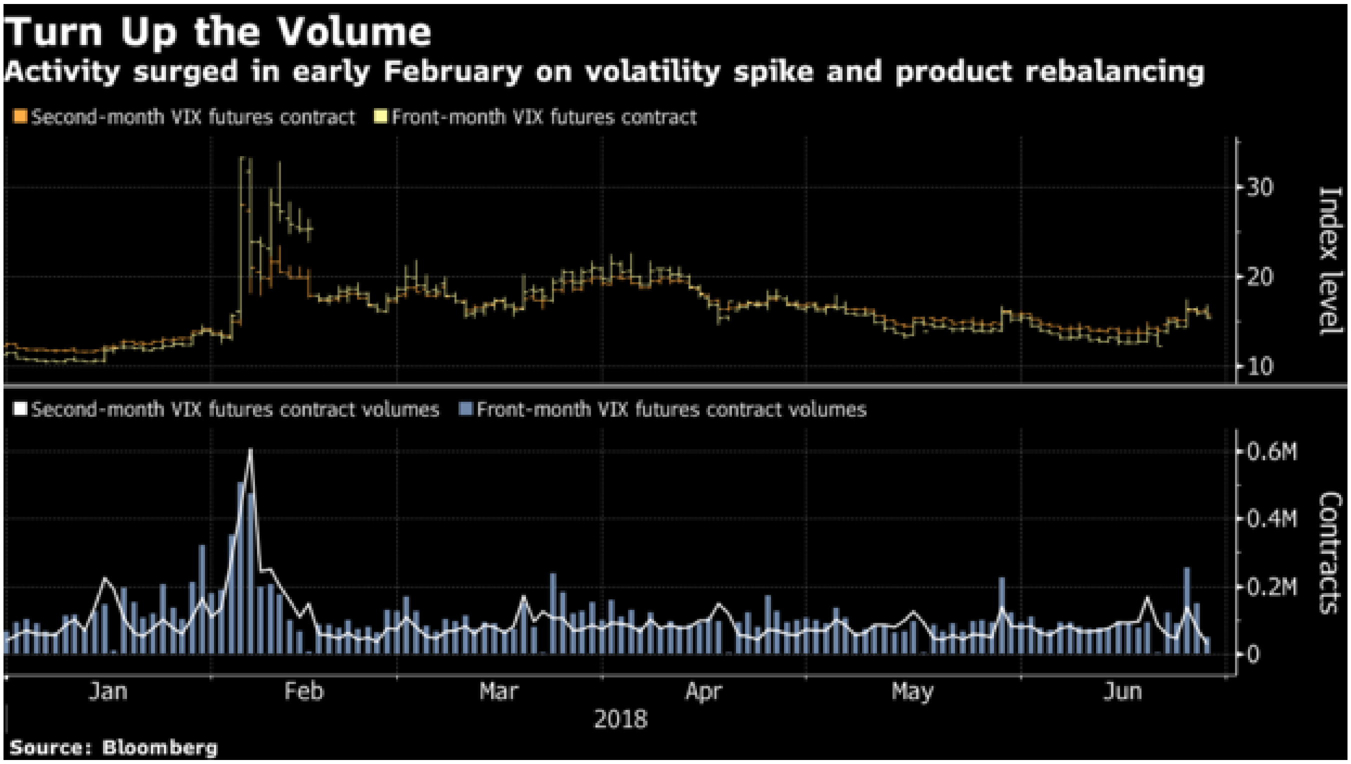
Capital Group Doubles Down

Source: Bloomberg

The spike in volatilely last February made a small hedge fund out of Austin a sizeable 6,000% gain. The $7.5 million Houndstooth Capital Management, led by Lincoln Edwards, is on the hunt for another big trade in 2018.

This time focused on the relatively small $413 million ProShares Ultra Vix Short-Term Futures Fund. It’s not the expected spike in volatility they are looking to profit from. It’s the reverb that comes afterwards that they are looking to profit from.

A Vexing VIX Trade



Source: Bloomberg

Like manias of the past, cryptocurrencies are now quietly dying on the vine. Bitcoin has broken down and is now off 60% for the year. While other crypto coins are going to zero. Great interview with Nobel laureate Robert Schiller on the social phenomenon that is crypto investing.

Trough Year for Bitcoin

Source: Bloomberg

And an even tougher year for the many initial coin offerings that have failed. The list is long and growing longer by the week. TokenData can provide you with the full list of planned offerings, current live coins, and the hundreds that have checked into the "digital graveyard".

	Name	Symbol	Status	USD Raised	Month
	Biofactory Coin		Failed		Feb 2018
	Flipz		Failed		Feb 2018
	Metta		Failed		Feb 2018
	Worldtelevision Coin		Failed		Feb 2018
	CycloShieldCoin		Failed		Feb 2018
	ARNA Genomics		Failed		Feb 2018
	Javvy		Failed		Feb 2018
	MAJATO		Failed		Feb 2018
	BASIS		Failed		Feb 2018
	Pocketinns		Failed		Jan 2018
	CrowdDrive		Failed		Jan 2018
	Volk		Failed		Jan 2018
	RealEstate Token		Failed		Jan 2018

Goldman Sachs' future CEO, David "D.J. D-Sol" Solomon just released his first single and summer mix "Don't Stop". The new age version of the Fleetwood Mac classic is available on iTunes and Spotify.

"D-Sol"

Source: Business Insider

Stillwater Capital: If it means we can get on Goldman's emerging manager platform we will download this one as much as is humanly possible.

Diversions

The FIFA World Cup continues in Russia. Our favorite to advance, Germany failed to move on as did Messi and Ronaldo. Mexico is now North America's favorite "hijo". And Argentina's football hero and legend, Diego Maradona, continues to live "la Vida Loco".

Maradona was seen at the stadium binging on white wine, passing out in his seat, and then giving the fans the international sign for "you're number one!"

Diego Being Diego

Source: Business Insider

Stillwater View: Looks like someone could use a hug, or a month at Passages Malibu. You honestly can't make this stuff up.

Sun Microsystems founder Scott McNealy has listed his longtime Palo Alto home for $89 million. *The San Jose Mercury News* gives you the specs, as well as the photo tour. McNealy purchased the home in 1982 and has been expanding ever since. It comes with a hockey rink, “safe room”, and a specially designed pizza making spa.

Scott is using REX Real Estate to make the transaction happen. It’s a startup McNealy invested in and where he also sits on the board. REX looks to apply AI to residential real estate and charge an all-in commission of 2%. Makes sense given the margin pressure that every other industry is seemingly suffering through.

Scott McNealy’s Compound in Palo Alto

Source: San Jose Mercury News

Stillwater View: We wish Mr. McNealy well in his attempts to sell the house. As a side note we point out that Scott named his sons Maverick, Scout, Dakota and Colt. Which begs the question, what did he name the family Labrador?

Looking to juice your Fourth of July with a little “Hollywood Magic”, then look no further than the final scene in Mel Gibson’s 2000 film *The Patriot*. While long faux blood and guts, we have it on good authority that no horses were injured in the filming of this movie.

For those looking for a little deeper meaning, there is the short version from the Ayn Rand Institute. They point out that our independence was the first one truly free of the crown, the pope and the state.

Any way you choose to interpret it, we are indeed all very lucky to live under the banner of freedom that independence provides.

The Signing of Declaration of Independence

Source: History.com

As promised earlier, here is the short and skinny on how to “de-risk” your 4th of July barbecue. We are going to keep it simple and straight down the fairway. We’ve given you the club, now enjoy.

1) Homemade fried chicken = Extra crispy KFC in the oven with every red and white tub safely sent to the trash before your guests arrive. They will never know.

2) For hot dogs it’s Nathan’s Famous every time. Just long enough to fill any bun. And because they are skinless there is no risk of breakage. Boil half of them and grill the other.

3) If you are engaged in a community chili cookoff, use Bruce Aidelle’s Texas brisket chili recipe. Bag the butternut squash and announce to everyone else that they are all playing for second.

4) Say no to all offers to “bring desert” to your party as your table will wind up looking like a yard sale. Instead get your hands on as many pies as necessary (blueberry, cherry, apple, rhubarb) and serve them up warm with vanilla bean ice cream on the side. Nobody, and we mean nobody, will throw shade on that lineup.

5) Most importantly, ribs are to be cooked for 2 ½ hours in the oven at 200 degrees covered in foil with a very basic dry rub. They are then grilled for 30 minutes with a “homemade” barbecue sauce to caramelize and finish.

   If by “homemade” that means opening a bottle of Sweet Baby Rays and mixing it with a slab of butter, lemon juice, Worchester, and mustard so be it. Your guests will think you are amazing. When in doubt revert to Twillard Mayweather’s phenomenal Tennessee inspired recipe.

Mr. Mayweather’s Finest

Source: Saveour

Enjoy the Fourth of July. See everyone on the other side, hopefully with a few fish stories in hand.

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