How's the Living?

Judging by the number of 'out of office' replies we get these days, the heart of summer is here, and the noise of the markets is hopefully in the rear-view mirror of the family truckster, or the window nearest to seat 1A.

Don't worry though, some of us will be staying at our posts, trying to make sense out of both the top-down and the bottom-up. As we look across the landscape, two narratives have emerged. One is of an economy with the gas pedal down to the floor, and another that is downshifting. The markets don't care either way, they are currently doing 90 in a 65, with not a highway patrolman in sight.

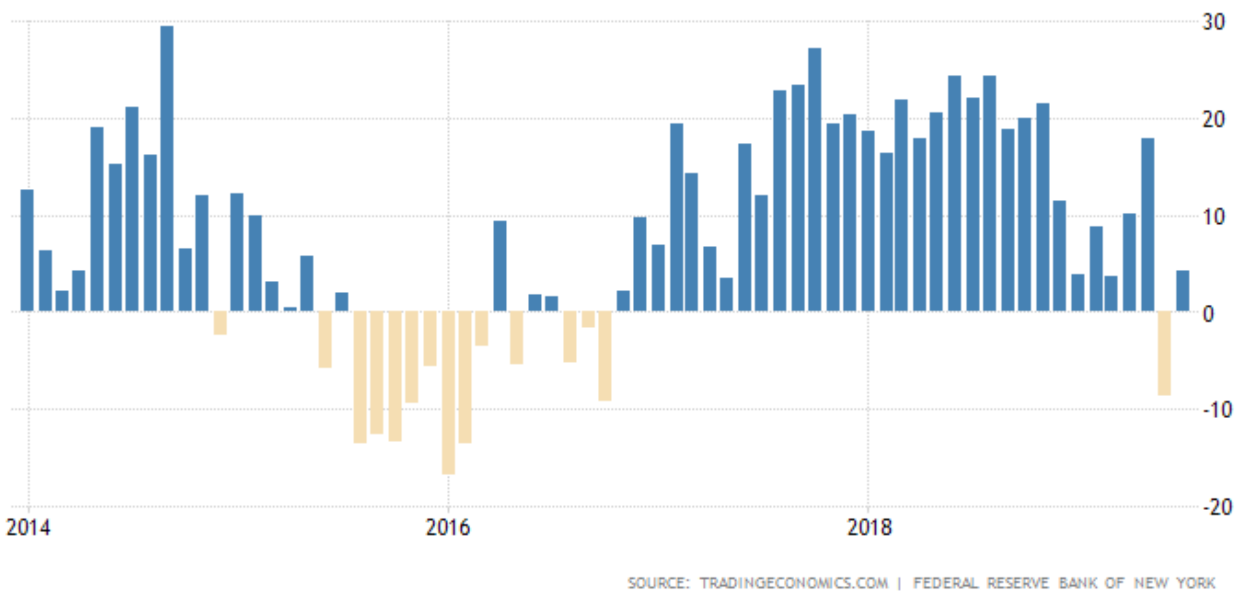
Wally World or Bust!

Source: Warner Brothers

The Economy

Fortunately, it was a quiet week from the top-down, with little on the calendar. The only readings of note were the regional manufacturing indexes from Philadelphia and New York. The former had a nice rebound, the latter limped across the line.

New York State of Mind



CNBC's senior economic reporter, Steve Liesman, commented this week that if the Fed pulls things off, they will be cutting rates at the very moment the economy slows. To be clear as the day is long, it will be the single best timing of the economic cycle in the history of the Fed. In the past, the body simply has never been great at nailing the landing. The equity market is giving Powell the benefit of the doubt, banking on fifty basis points of runway foam just in case.

Waiting on Arrival

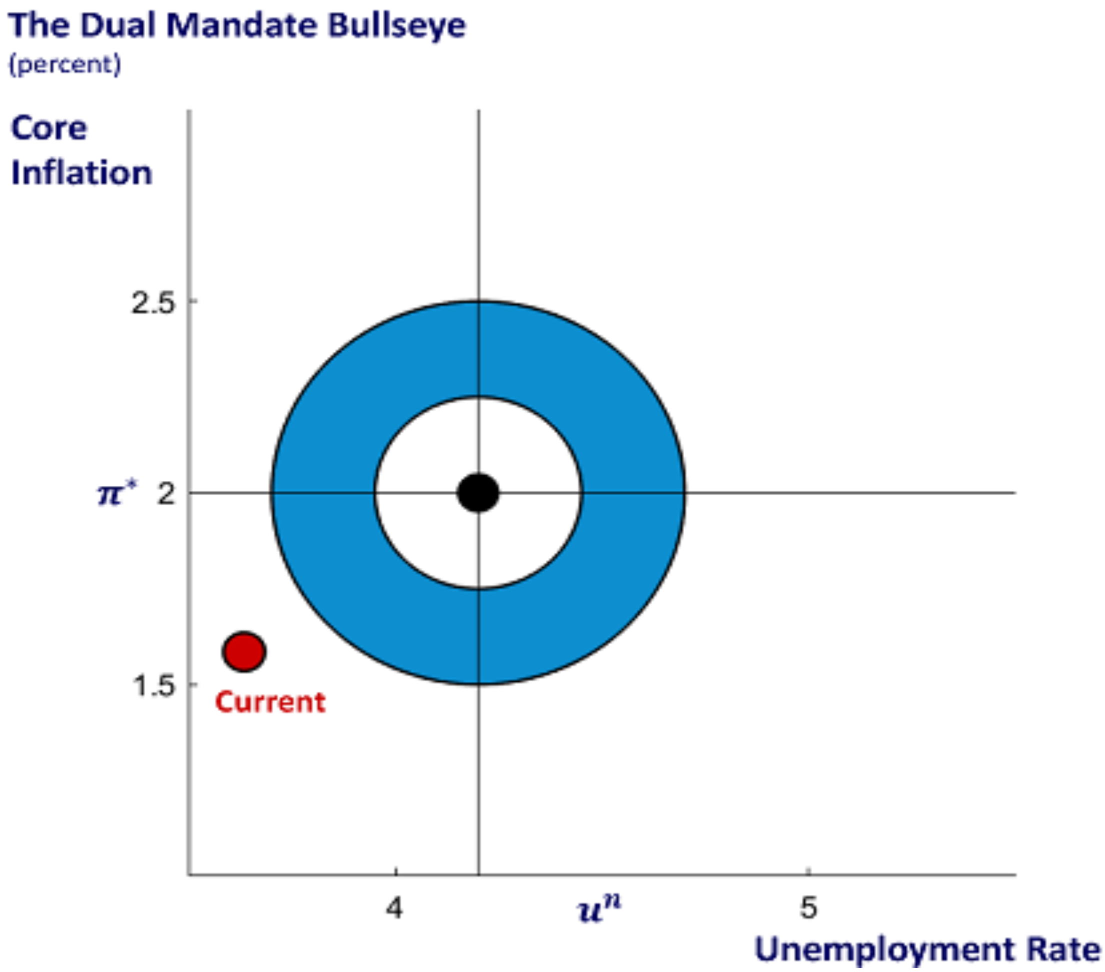
Source: iternegoce

If you have been a regular reader of *This Week in the Markets*, you might be asking yourself 'what does the author who writes this piece have against economic expansion'? The truth is, nothing. Times like these are when returns are above average, sometimes well above average, and economic plans shift from just getting by, to getting ahead. And these are all great things.

SPY & DIA

The exact language of the directive the Federal Reserve was given by Congress was to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates". By virtue of what the Chicago Fed provided last week, rates have plenty of room to go on the downside because inflation has been so sanguine. For those interested, the Central Bankers of the Windy City provides a deep dive on the subject.

Off the Mark



Source: Chicago Federal Reserve

In a sign of just how triggered the market is right now by central bank activity, New York Fed President John Williams had to revise his remarks on Thursday that were taken as a sign that big things were to come at the next FOMC meeting. President Trump would Tweet that he preferred the first version of the speech, over the amended one.

Donald J. Trump Verified account @realDonaldTrump
FollowFollow @realDonaldTrump
I like New York Fed President John Williams first statement much better than his second. His first statement is 100% correct in that the Fed "raised" far too fast & too early. Also must stop with the crazy quantitative tightening. We are in a World competition, & winning big,...6:38 AM - 19 Jul 2019

The challenge emerges when it appears that maintaining stable asset prices becomes part of the mandate. And that is what we think is happening to some extent. Add to that a president whose only opinion poll that matters is the level of the S&P 500 and Dow Jones, and you can see how a reasonable person might think that fiscal and monetary stimulus in the form of tax cuts and reductions in interest rates could be acting as a guaranteed floor on the market and asset prices.

Our view is this, akin to wildfires, it's better to experience a few smaller burns with regular frequency, than a giant inferno that gets out of control. The former was the shallow recession we saw in 1990, the latter being the 2008 global financial crisis. If you help manage and grow other people's money like we do, you hope for 1990, but prepare for 2008.

The Shallow Recession of 1990

Source: PBS

The Global Financial Crisis of 2008

Source: CalFire

The Markets

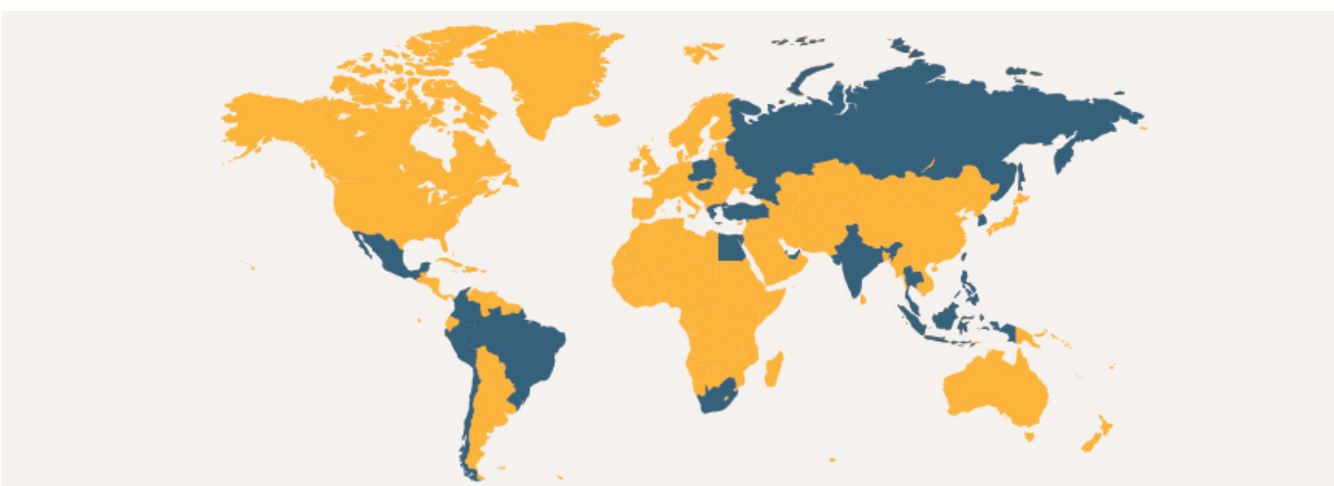
Once again, the headlines were filled this week with calls to de-risk, protect profits, or take money off the table. Which of course gets more painful by the day for those who have already done so. Here is the quick whip around the horn from those who sang the loudest this week.

First up, the once venerable Deutsche Bank. And while we say, 'once venerable', DB's asset management arm still runs over $300 billion for individuals, institutions, and endowments. The firm's Chief Investment Officer, Christian Nolting, continues his call to reduce risk exposure to U.S. equities, and re-allocate to investment grade corporate bonds.

Don't Overstay

Next up was the $50 billion Jupiter Asset Management, whose very own Alejandra Arevalo cautioned to get out of emerging market debt. He too thinks the landing zone for such assets should be high-grade corporate debt. As it relates to the Fed, he thinks the market euphoria surrounding coordinated global rate cuts will be short lived. "The markets are wrongly reading the Fed change of policy into something positive," Arevalo said "If they're cutting rates, it's because there's an underlying problem with their economies. We're becoming more defensive in what I think would be a more bumpy second half."

Emerging Markets



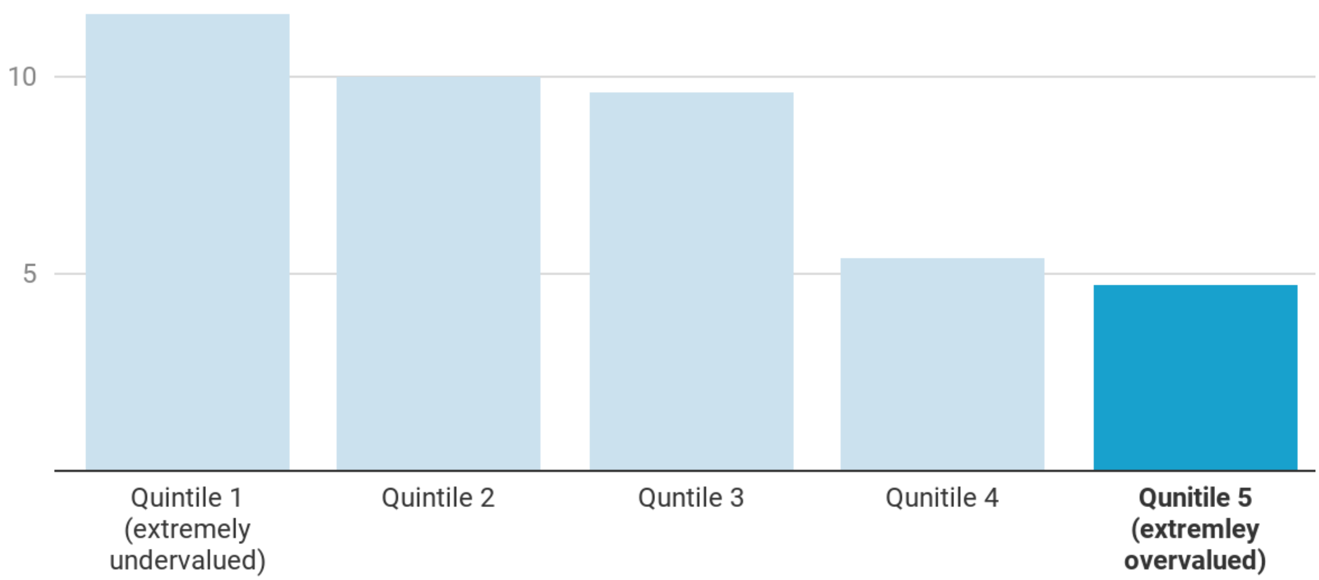
Source: MSCI

To round out this week's news that might make you want to marinate some ice cubes, the good people at Ned Davis Research point out to us that when stock valuations are this high, returns tend to be muted, like 4.7% muted over the 10 years that follow these moments.

What Lies Ahead?

"Extremely overvalued" market = much lower returns

Chart shows the S&P 500's median 10-year annualized returns depending on valuations. S&P 500's GAAP price-to-earnings ratio is currently in the top quintile.



Source: Ned Davis Research • Get the data • Created with Datawrapper

Companies & Earnings

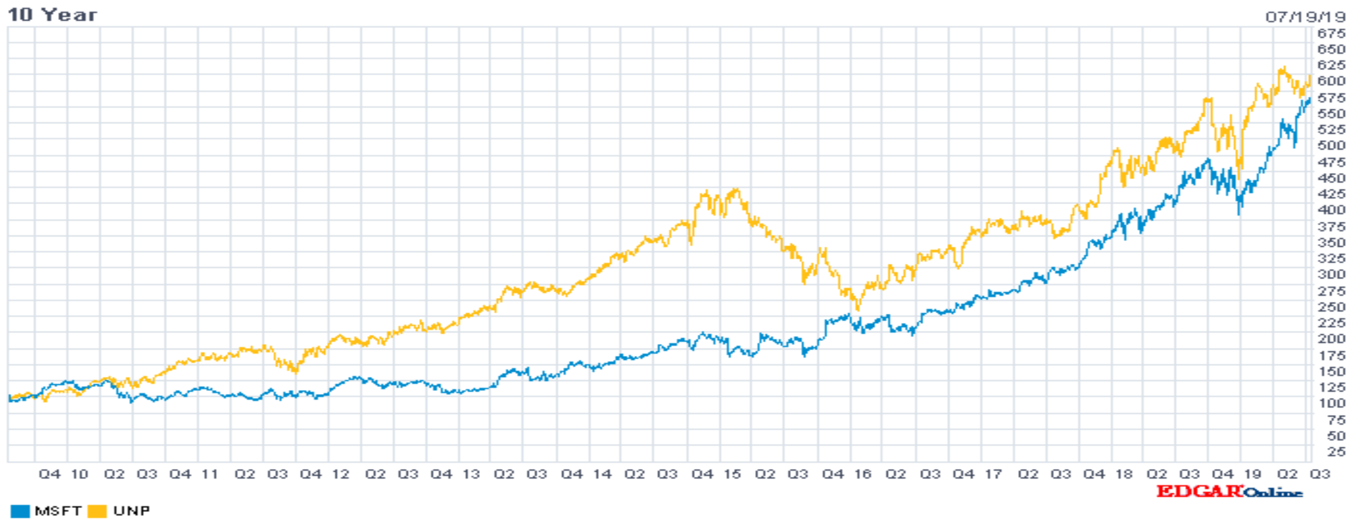
And now a quick run through the good, the bad, and the ugly of earnings so far. Full disclosure, if we could change the 'bad' to 'mediocre' we would, but that wouldn't allow us to use this picture as a setup. Plus, who would ever go see 'The Good, The Mediocre, and The Ugly'.

Source: brothers.inc

Companies who reported what Wall Street considers 'good quarters' consist of just about every blue chip there is. The list includes Microsoft, J.P. Morgan, Union Pacific, and Johnson & Johnson, all of which you can own in single stock holdings or via the Dow Diamond ETF, with an extremely low cost to own.

Now if we asked you which stock has outperformed more in the last ten years would you have guessed Microsoft or Union Pacific? With a high degree of certainty, we think you would have picked the little Seattle based software maker over an old railroading company. And you would be shockingly wrong. Union Pacific >>> Microsoft.

UNP uber alas MSFT



In related railroad news, the CEO of the east coast's largest rail operator, CSX, commented that…

"Both global and U.S. economic conditions have been unusual this year, to say the least, and have impacted our volumes. You see it every week in our reported carloads. The present economic backdrop is one of the most puzzling I have experienced in my career."

You know it's tough out there when a person with a purview unlike any other is still trying to figure out what the different cross currents mean, and how to navigate them successfully.

All Aboard?

Source: CSX

Chewy, which was spun out of PetSmart this year, gave the Street their first look at earnings on Thursday and it gets our 'bad' award this week simply because of the disconnect between a private market and public market value.

This week the pet 'e-tailer' announced revenues of $1.1 billion in the second quarter, and a significant 45% rise in subscribers for home delivered pet goods. We also applaud the company, and their lead underwriter J.P Morgan, for taking advantage of a very 'festive' market and the wide-open IPO window to float shares to the public in June.

Everyone Loves a Puppy!

Source: Reuters

But that is where our respect and appreciation for CHWY stops, and here's why. Everything about this company going from private to public, and how it now trades reeks of a bubble. Let's count the ways…

- In 2017 PetSmart paid $3.35 billion for the company. Two years later it went public at a valuation of $9 billion. The stock went up 60% on the first day of trading. One month later the company was valued at $14 billion.

- The total market for home delivered pet goods is estimated to be $70 billion. That means that Chewy is currently valued at roughly 20% of the entire addressable market. If the company's net profit winds up being 25%, or $1 billion a year from now, that means they are valued at a quarter of the entire market value, with $1/70^{th}$ the net profit.

- Public market valuations, and private market valuations are vastly different. We can say with a high degree of certainty that if an acquirer were to pay the current value of

CHWY, and the prospective cash flow of the business, they would never turn a profit. Never!

- And then there is this gem from the *Wall Street Journal*…

  "***Chewy, founded in 2011 by Ryan Cohen and Michael Day, calls itself the "largest pure-play pet e-tailer in the United States." It has distinguished itself from many of its competitors with customer service that includes 24/7 access and two-day shipping of online orders.'***

  If this story is at all accurate, and the company's competitive advantage is '24/7 customer service and two-day shipping', Chewy's defensive moat is as shallow as a kiddie pool.

Chewy 1.0

Source: ABC News

In a big win for the home team, wunderkind Reed Hastings and Netflix finally had their day of reckoning, and it wasn't pretty. When the company released earnings it disclosed that subscriber growth in the U.S. had gone negative, dropping a net 130,000, and global sign ups where half of the five million Wall Street expected. None of which is either good, or acceptable, for a company that has fueled its growth on high levels of debt, and low levels of free cash flow.

Netflix…on Fire!

Earlier we called this a win for the home team, which it was. For the past two years we've been picking off FANGs that are beginning to stumble. It started last year with Facebook, and the Cambria Analytica data breech debacle. Our search for trouble didn't end there. Earlier this year we initiated a short position in Netflix for essentially the exact reasons it is beginning to falter; higher costs, price increase pushback, and greater competition.

With a debt level this high, and cash flow running this low, the ingredients were set for a good short sale recipe. We also think the rest of the Street has gotten 'fat and lazy' when it comes to owning the FANGs, and nothing will get you back on the treadmill faster than the biggest loss of market capitalization in a decade, which is what Netflix did on Thursday.

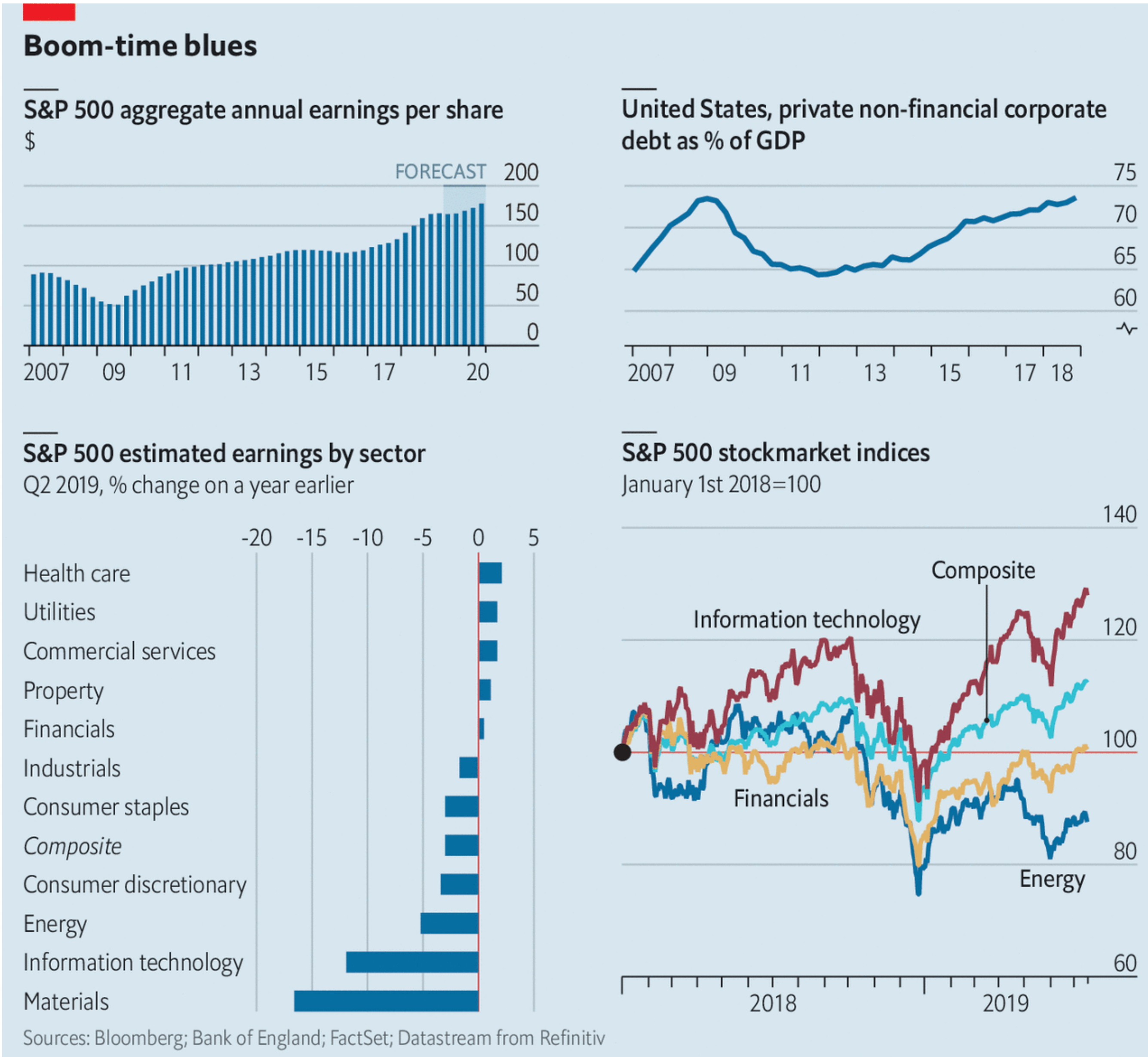
FANGs Lose Their Bite

The Economist piled on the bad news this week with a headline that read ‘Profits are Down at America Inc.’ We read the article and thought to ourselves that the author put the same set of facts and fears, into the exact same blender everyone else is using right now and came out with the same sour tasting cocktail. Meet Isaac, your bartender!

‘I Make Your Drinks…’

The story from the *Economist* started with the quote from J.P. Morgan's, Jaime Dimon, who said during the company's earnings call 'It's NOT that bad'. Which of course it isn't, and the charts provided below even says that. The story just happens to have a caption that would say otherwise.

Where's the Crisis?



The Economist

Diversions

While the film is a long way off, like 2020 off, the trailer for *Top Gun: Maverick* hit the street this week. Since we are living in a very divided country right now, here is the view of the film from the left, and from the right. Here, in the *Fighter Pilot Podcast*, a real TOPGUN instructor gives his scene by scene review of teaser.

Maverick himself, Tom Cruise, made an appearance at ComiCon in San Diego and provided his thoughts on the importance of the film. This writer could care less what anyone else has to say, I will be getting my speed need filled when the film is released on June 26th of next year.

Pete 'Maverick' Mitchell

Source: Moviehole

The golf major formerly known as the British Open is being held in Northern Ireland this weekend for the first time in 68 years. The venue for this year's 'Open Championship' is Royal Portrush. *Golf Digest* provides a look into what it takes to turn the course into a championship ready venue. The ever entertaining, David Fehrety gave *Sports Illustrated* his thoughts on what this year's tournament means.

Royal Portrush, Northern Ireland

Source: Royal Portrush

I have one very good Fehrety story from his earlier days that can be provided upon request, and one Macallan rocks to get my impression warmed up. Hint, it has to do with him hitting the 'loo' at the 1996 Los Angeles Open.

Fehrety on the Course

Source: Golf.com

The Hillsborough Concourse de Elegance takes place this weekend at Chrystal Springs, thirty minutes south of San Francisco. Founded in 1956, this is the longest running fancy car show in the country. *Vintage Road and Racer* provides a look at what attendees can expect this year.

Very Vintage

Source: Hillsborough Concourse de Elegance