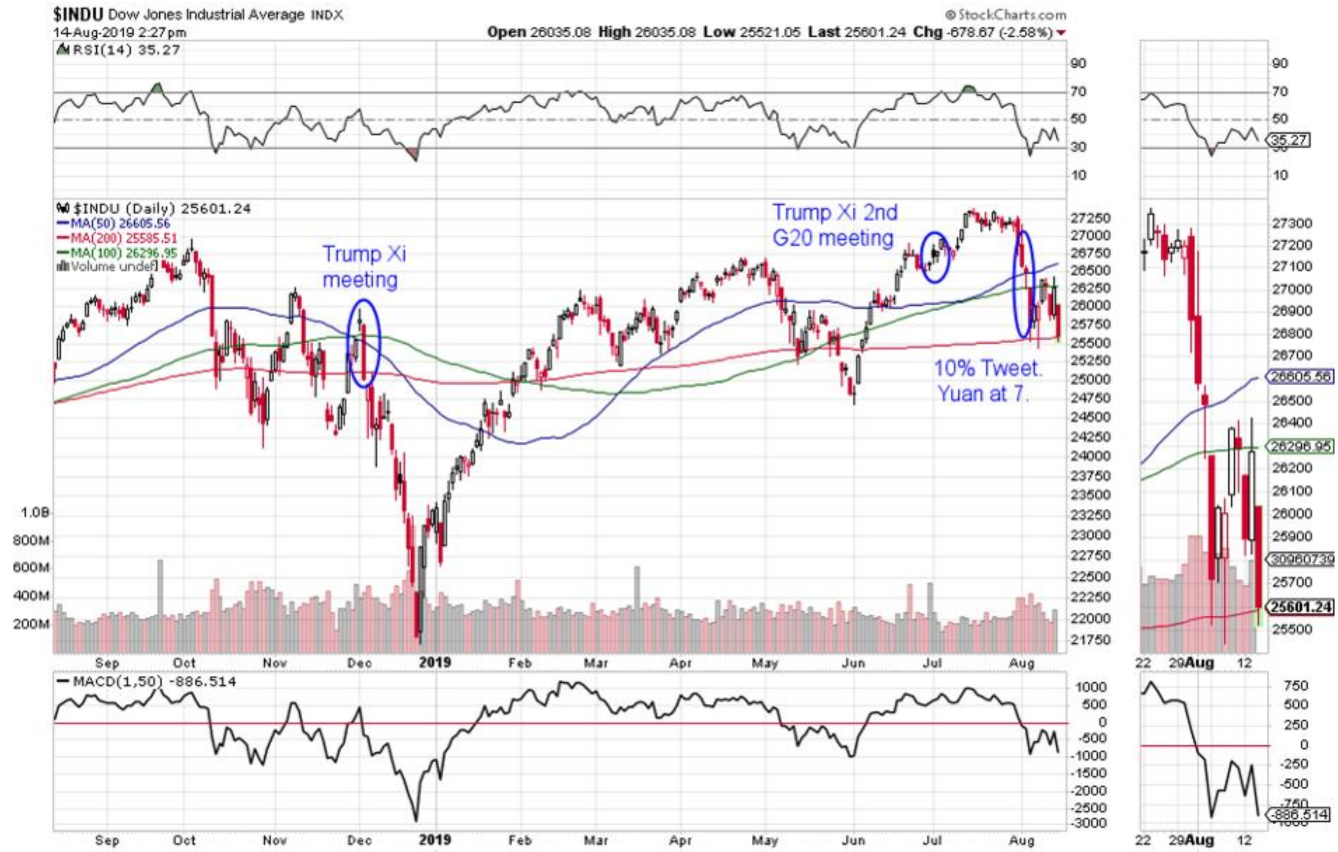
The Circus Has Arrived…

Things got interesting fast for the markets this week. Yields cratered again, Europe sweltered under an economic cloud, and the U.S. is becoming the cleanest dirty shirt around. And here's some news for anyone who calls under a rock home, the yield curve inverted. Add that to the chaos stirred up by our 45th president who likes to 'play the markets', and it's buckle up time, the show is just getting started.

The Economy

As much as we wish we could focus on the hard data, the melodrama that is the U.S./China trade fight once again gets top billing. On Tuesday, with impeccable timing, 15 minutes into the day's trading session, The Trump administration announced that tariffs on certain goods, including cell phones, would be held off until December for fear of disrupting the holiday selling season. The timing was 'curious' to some, although not so much to us. Forbes magazine contributor Chuck Jones, explains why the president was willing to cede some ground to China in order to support the markets.

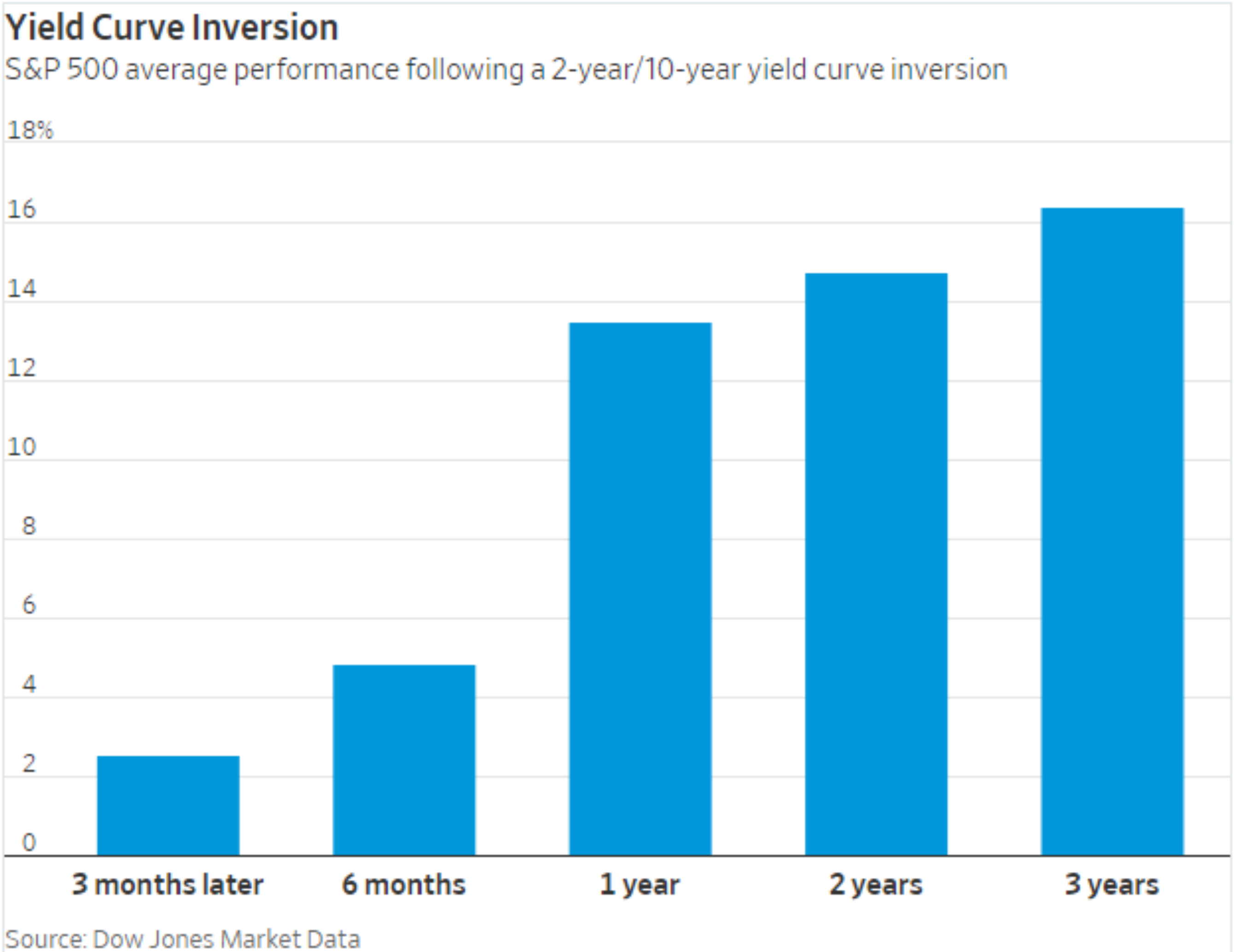
Markets are Getting Triggered



Source: Forbes

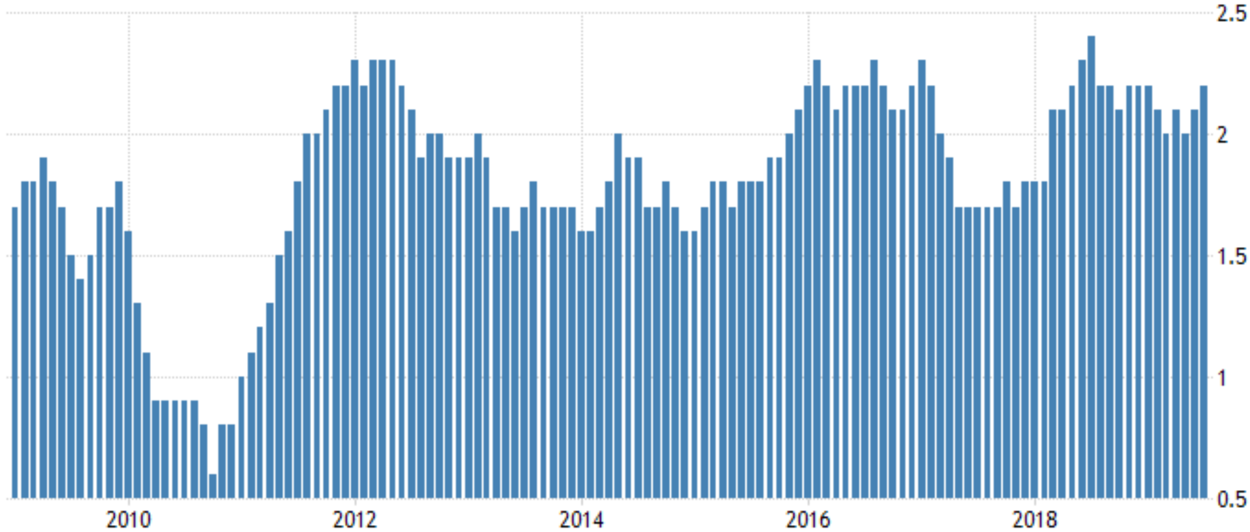
More on the subject of inversion and why you should care. In less than 60 seconds, a curve inversion simply means that short rates, the ones banks borrow at, are higher than the ones were they ultimately land. This happens, in part, because buyers of bonds want to keep duration short and not extend out further than necessary given economic uncertainty. That's why bank stocks had a tough week and are starting to confirm that all is not well. Good news for investors though, stocks tend do well after the initial inversion occurs, recessionary risk be damned.

What's to Worry About



The consumer price index rose more than expected for the second straight month in a row. Is this enough to alter the Fed's outlook on interest rates? Very unlikely, as they have been watching the same deflationary movie for ten years, so why should they be scared of one or two new scenes that surprise.

CPI Remains…Contained



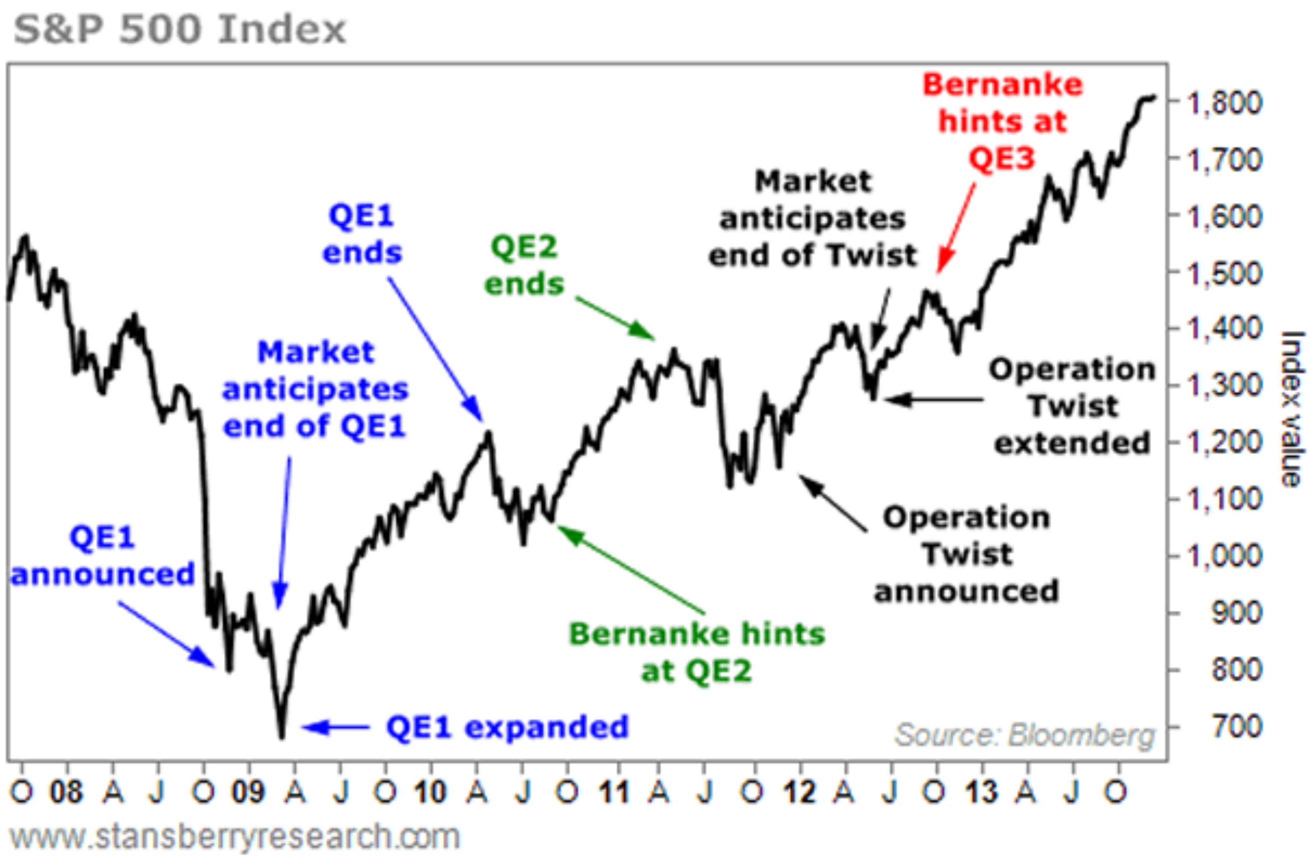
So, it's on to Jackson Hole, Wyoming where the Kansas City Fed hosts its annual gathering of every central banker willing to slum it in the Snake River Valley for a few days 'in late August'. Among them this year is our very own Jerome Powell. For years prior, the event went somewhat unnoticed, that is until Ben Bernanke used it as a platform to unofficially announce QE II in 2010.

The Grand Tetons

Source: REI

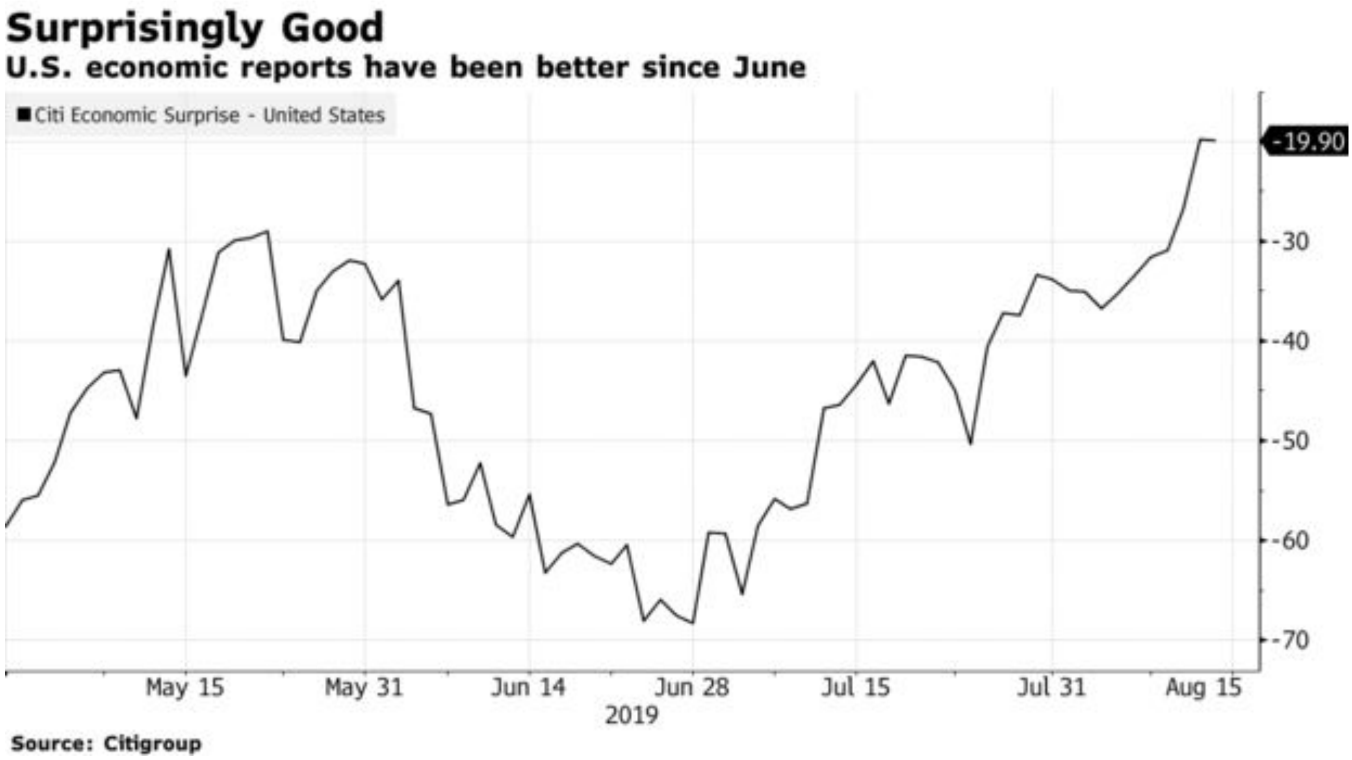
For those not in the know, QE II has nothing to do with large cruise ships but instead the second round of quantitative easing engineered by the Bernanke led Fed. It has been largely viewed as the Fed's way to remind the markets that there is indeed a put in place, and they will take whatever measures necessary to support asset prices, just as long as inflation stays in check.

QE-Palooza



Fast forward to 2019 and it's once again viewed as the reason the markets took off in January when Powell announced his 'pivot' and the Fed has since cut rates and is expected to do so again, even as the economic backdrop in the United States has improved over the summer.

United States...Uber Alas



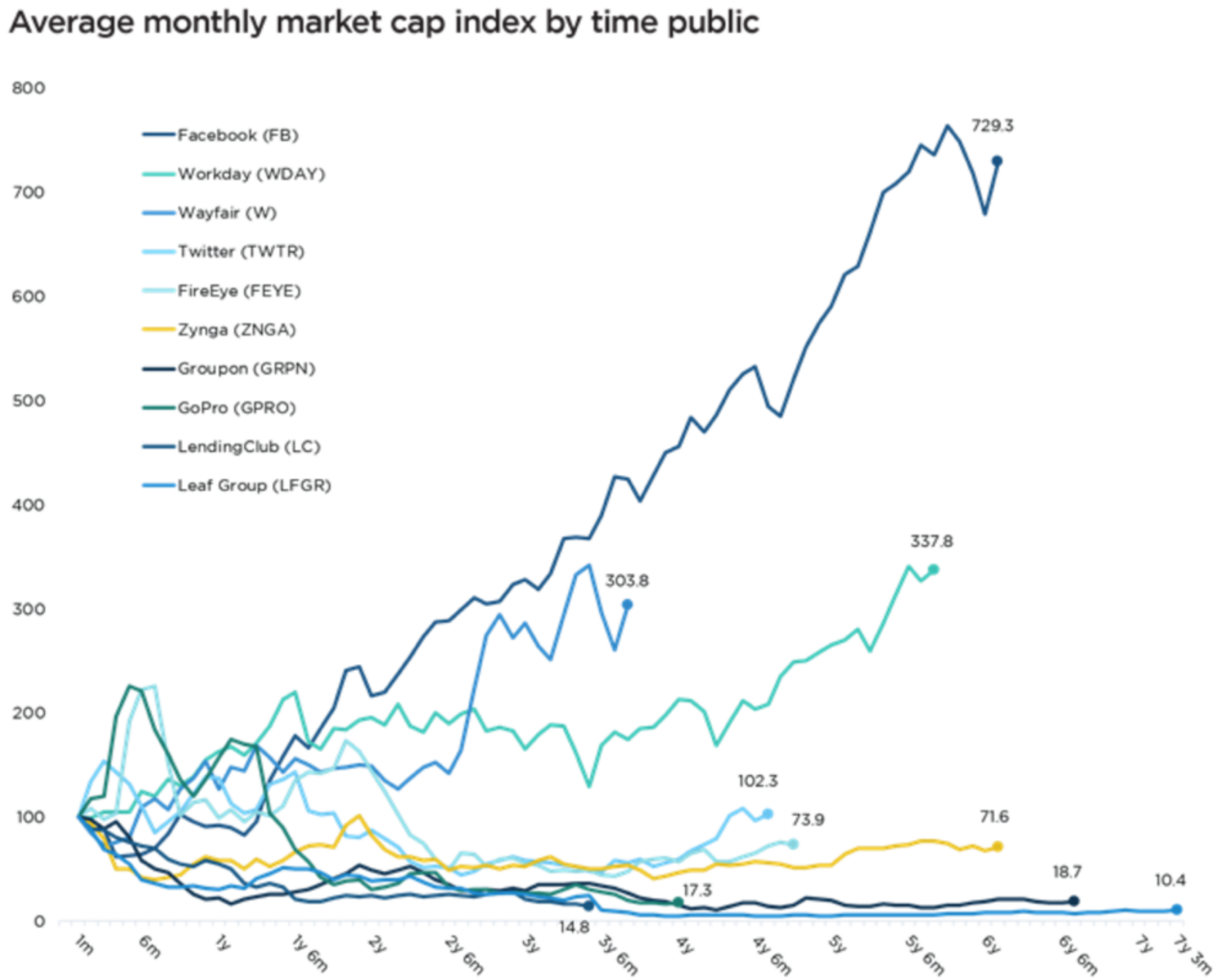
Private v. Public Valuations

If we are in an asset price bubble, and there is good reason to believe we are, then the wide difference in public market value versus private market value of many companies should narrow once the air gets let out, and we plan to have a 'bubble basket' of stocks ready to short when we think it happens.

The math we are working from has the basket representing a 10% position in the portfolio, with 1% per individual stock shorted. That provides us a margin for error should one of our positions see a short squeeze.

We are capping our losses out at 2%, which means the basket would have gone up 20%. If on the flipside, the portfolio gets cut in half, we add 5% of profits for our clients. A 50% upside to 20% downside is a risk-reward ratio we like. Keep in mind, if the basket gets cut in half, in all likelihood, the market will be lower, not higher, as well. If that's the case, we are providing downside protection while picking up Alpha when we are supposed to. Another setup we like, as do our clients.

Time Will Tell



Source: 1exchange

For the next few weeks we will introduce you to the ideas that will be included and add a little bit to the 'why they got invited' to the party. These ideas are not a slight on management or a claim of fraud, but more simply a put option on the extreme difference between public and private market valuations.

Every week the chorus of those who think the IPO cycle is reaching its nadir grows, and we have to admit, we concur. How do we know? The quality, and profitability of companies ringing the opening bell at the NYSE or Nasdaq grows by the week. Some of which are years away from being baked enough to be in the public markets.

One of the more controversial people in the tech investing ecosystem, Chamath Palihapitiya, has gone on record several times calling the current environment of venture investing a 'bizarre Ponzi balloon'. The idea being that VC firms live in this circular bubble, each investing at various later rounds, and pumping up valuations before taking an overhyped and not ready for prime-time company public. This is indeed how it feels today.

'Why is this man smiling?'

Source: BizJournals

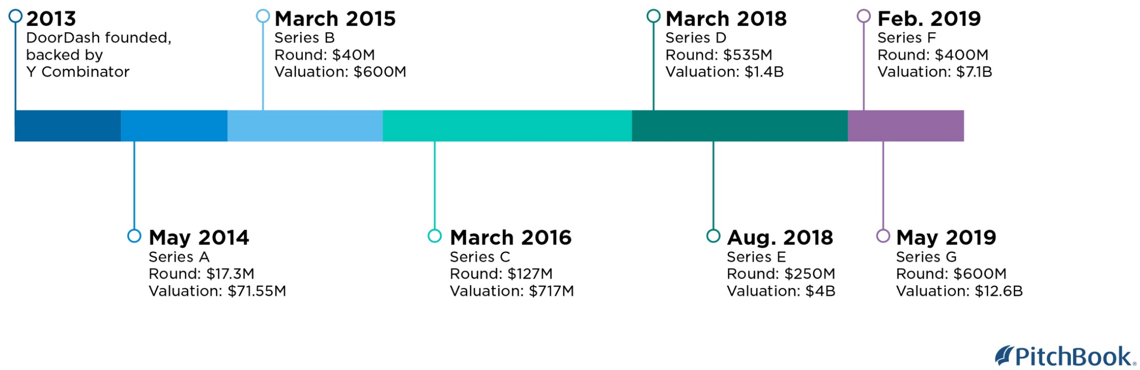
Full disclosure, while Stillwater doesn't endorse Ponzi schemes, we are certainly benefitting from the current state of unicorn hysteria. We just happen to sit in a position to bet against the shares as the hype fades and the hangover kicks in. Find me someone who likes a hangover, and you've also found me someone with a major drinking problem. As long as Fed Chair Powell keeps spiking the punchbowl with 80 proof Vodka, we think that trade continues.

Drink Up!

Source: Mandatory

The Wall Street Journal profiled the situation twice last month. Once with a story entitled "Public Markets Expose the Myth of Unicorns." In the other, it chronicles the astronomical rise in DoorDash's private market valuation. The food delivery service is currently valued at $13 billion, up 10x from where it was valued in early 2018.

Bubblicious



With that out of the way, we introduce you to the first three names in our bubble basket. They are Chewy, Beyond Meat, and Zoom Technologies. Onward we go in setting the stage.

Chewy, which was spun out of PetSmart this year, gave the Street their first look at earnings in July and it makes our list because of the disconnect between a private market and public market value.

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 1/70th 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!

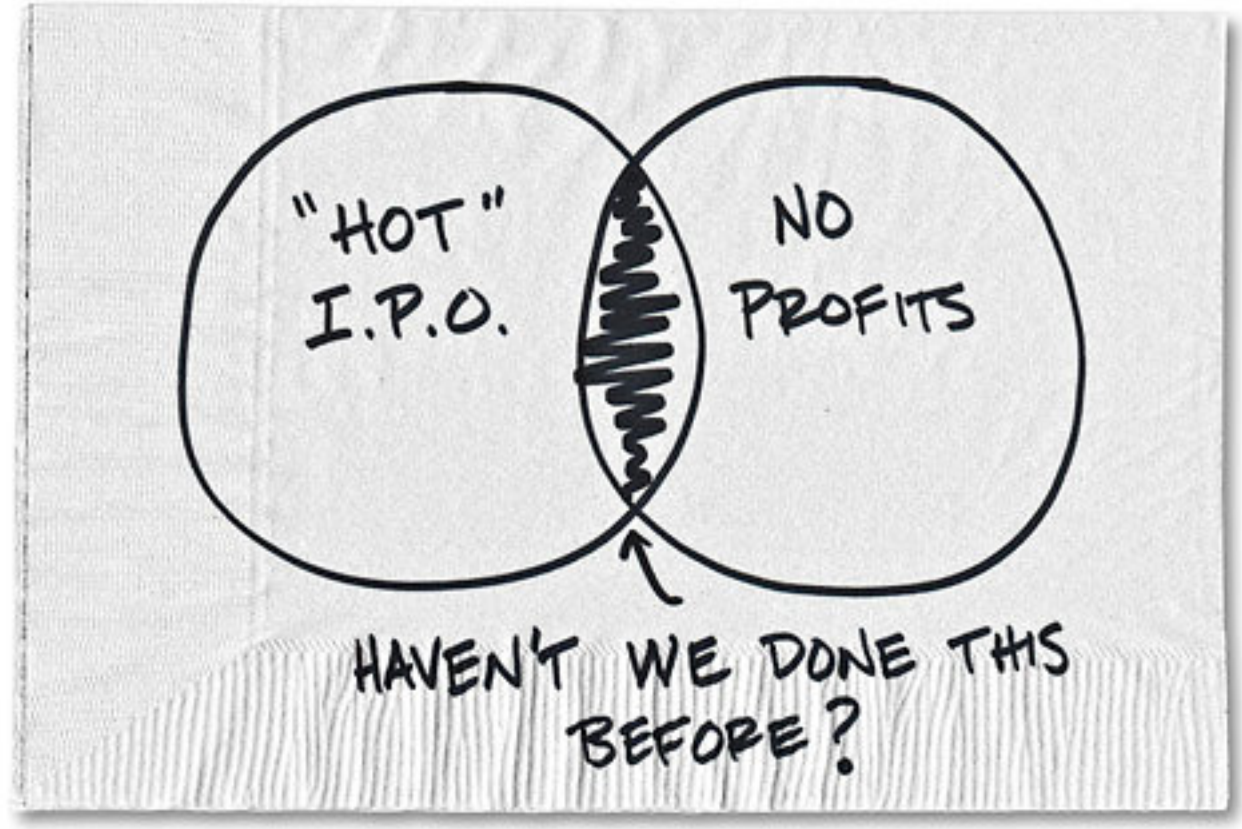
- And then there is this gem from the *Wall Street Journal…*

  "***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.

David Einhorn also thinks Chewy is Pets.com…round two. Of course *Dealbreaker* thinks they stumped everyone six months ago and can claim ownership. How bout we all agree that the joke is so incredible easy, we all get to claim it, use it, or do whatever we damn well want with it? Let's just see who makes money from it. Game on.

The Sweet Spot



Source: New York Times

In news that helps confirm the shift in consumer tastes, the shares of Beyond Meat continue to defy the skeptics, even as the valuation of the company goes through the stratosphere. Originally valued at $2 billion when the IPO occurred back in May, the company rose to $12 billion at the end of last month. The 700% move in the shares caused insiders to cash in some chips last week when Beyond Meat issued a secondary offering.

This took some of the juice out of the stock as the fresh inventory of shares weighed on the stock price, that said, the company is still worth a cool $9 billion. While we don't have an active position in the shares, this has similar markings to the aforementioned bubbly water craze, and BYND could be the next LaCroix. Be on the lookout for Walls Street's first vegan ETF to come out shortly.

Beyond Sanity

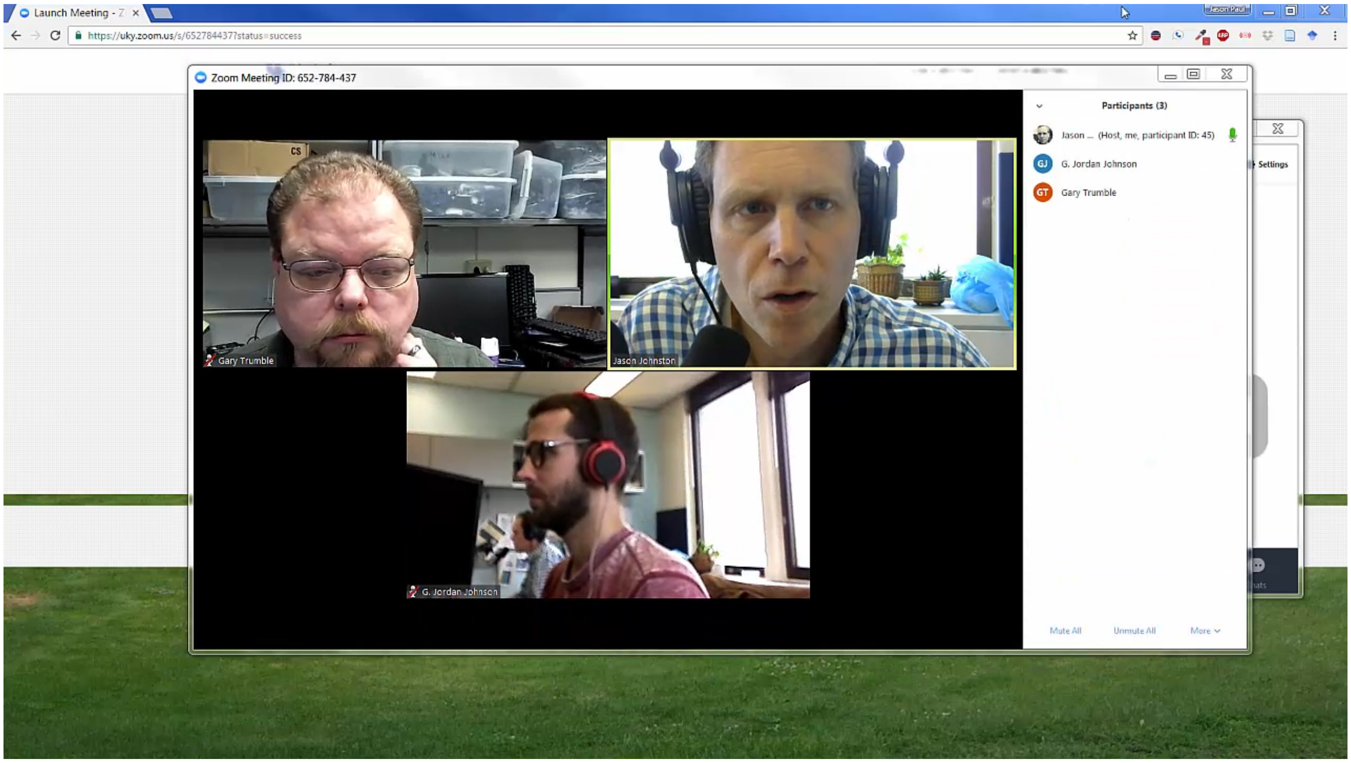
Source: Fortune

In a sign that the venture capital froth machine is pumping at a fast clip these days, teleconferencing company, Zoom Video Communications, priced their public offering at $36 a share last month, and it opened at $65 the following day.

Stillwater has been using Zoom for the past two years, and we love the technology. What confuses us though, and quite possibly the reason we stick closer to home and do not buy IPOs, is that we are still amazed that somehow, someway, this technology was not developed sooner.

Zoom CEO, Eric Yuan said something rather awesome on the morning of the IPO in an interview with *Bloomberg*. When asked about the pressure of being a public company and the price of Zoom's stock, Yuan unexpectedly said that he "thought it was too high". This is not something you typically hear from fellow instant billionaires who are riding the Unicorn monetization wave.

Zooming In

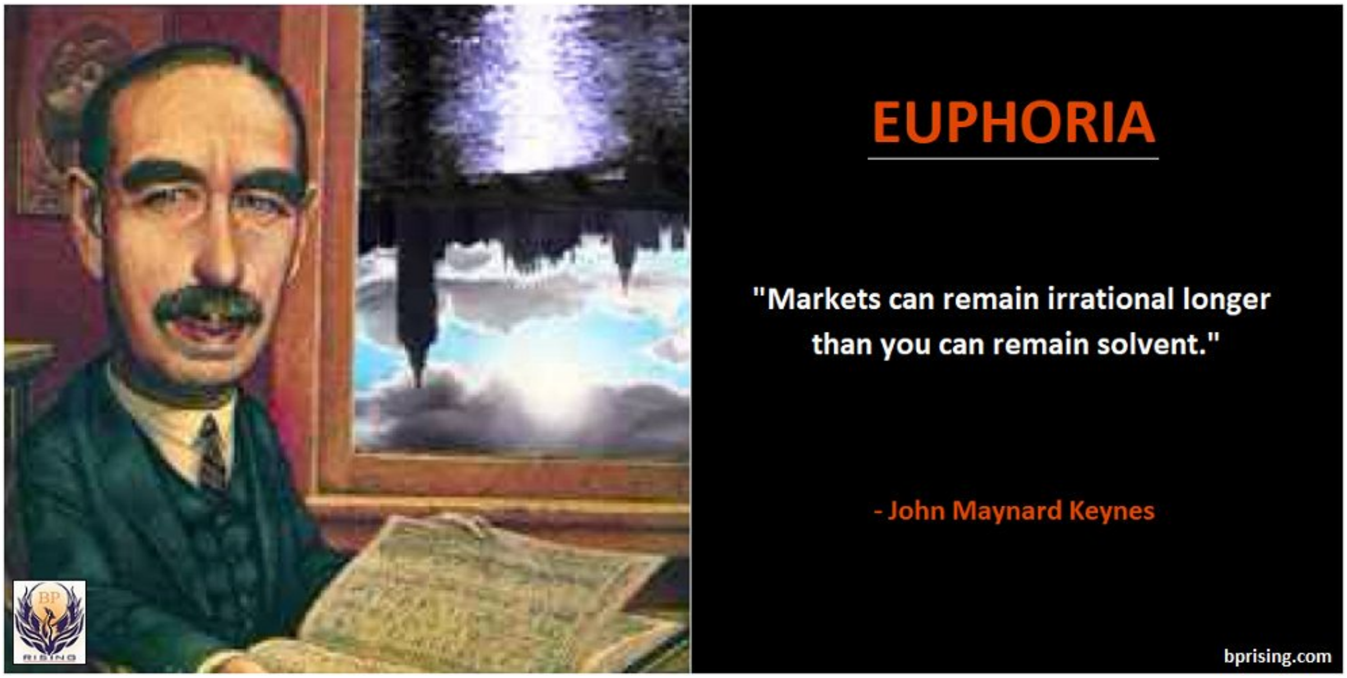


Source: Higherlearning.com

Disclaimer: Stillwater doesn't make recommendations; we manage money, and through *This Week in the Markets*, we tell you some of the things we do along the way. Short selling is not for the faint of heart and can be painful for that particular bodily organ as well. That said, it can make you a lot of money and smooth out returns. We've used it heavily over the past 18 months for our Hedged Equity Income Strategy and are carrying a 14% gain while maintaining an average of 50% net exposure. The S&P 500 has returned roughly 8% during the same period.

If you are thinking about putting this short basket on and are not an investment professional or can't stomach volatility, we would counsel you against it.

A profitable 'bubble basket' short trade needs real fear and risk to come back to the market to be profitable, and that can take longer to happen than one would hope. As the famous economist John Maynard Keynes once said…



Source: Twitter

Mid-Year in the Markets

For all the fanfare about what a great 'tape' it's been, the markets have really only been trading sideways for the past eighteen months, which says a lot about the severity of last years fourth quarter selloff. The S&P 500 and Dow Jones Industrial Average are within 400 to 600 basis points of being flat for the period, while the Nasdaq has racked up a modest 14% return. None of which screams that we are still in a bull market. DoubleLine founder Jeff Gundlach, has made this point several times recently.

S&P 500, Nasdaq, Dow Jones

Drop that down to the baskets of companies in the same industry, and the picture painted is not one of a healthy growing economy. Two of the four major sectors are flat, to slightly down, leaving technology as the standout, and healthcare as an 'also ran'. Of all the sectors, industrials are probably most effected by trade headwind. Banks are having a tough time as a flat yield curve impacts their profitability. What does this all mean? The past eighteen months has been a period of consolidation, with a lot of spikes higher and lower, with little to show for it. This is the stuff of a tired, late in the cycle, market, which is what makes the most sense to us.

Technology, Health Care, Industrials, Financials

If you leave the sectors behind, and instead look at 'factors', the story gets really interesting. Years ago, Gene Fama at the University of Chicago, did some pioneering research on the subject of what have caused certain parts of the market to outperform or underperform over time. What his work showed was smaller capitalization stocks outperformed larger ones, and that value stocks beat growth….over a full market cycle, both of which have been woefully untrue for the past two years and are conditions typically found when bull markets get old and the economic cycle matures.

Large Cap, Small Cap, S&P 500

Growth, Value, S&P 500

Most of these charts would be palatable, except for the fact that so many investors are in DFA, or similar, factor-based strategies. One of the keys to the concept of small over large, value over growth, momentum, and profitability is that advisors and DFA must always add that the outperformance comes 'over a full market cycle'.

The problem with this, is the spread widening between value and growth you saw above has been going on for an uncomfortably long time. And year after year of trailing the S&P 500 by 200 basis points not only adds up, it starts to draw client's attention and can force a tough conversation. Just ask Cliff Asness and his firm AQR, who are seeing challenging performance and mutual fund redemptions. So much so they are trying to find tenants for some unused space in Greenwich.

The Quant Master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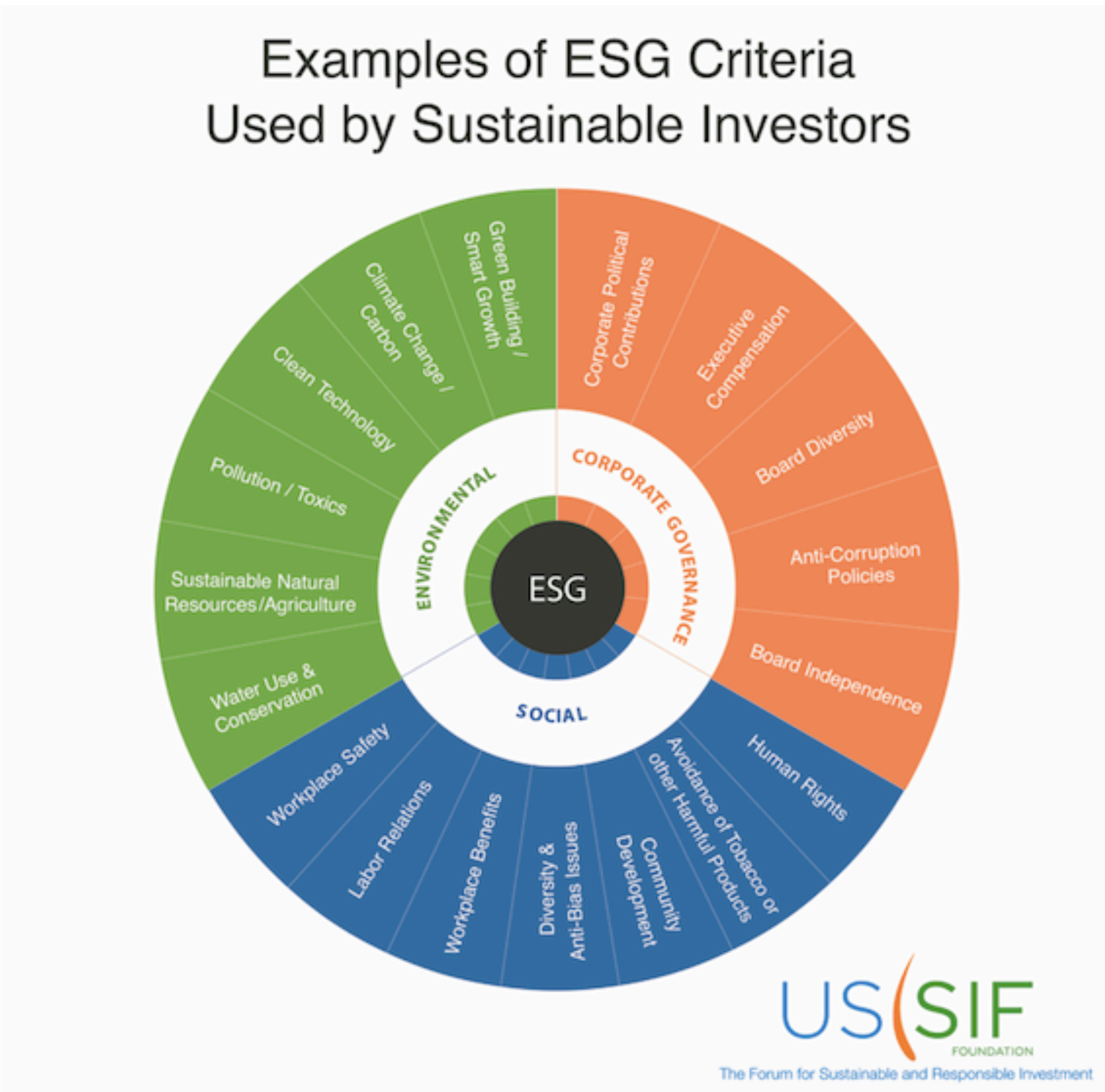
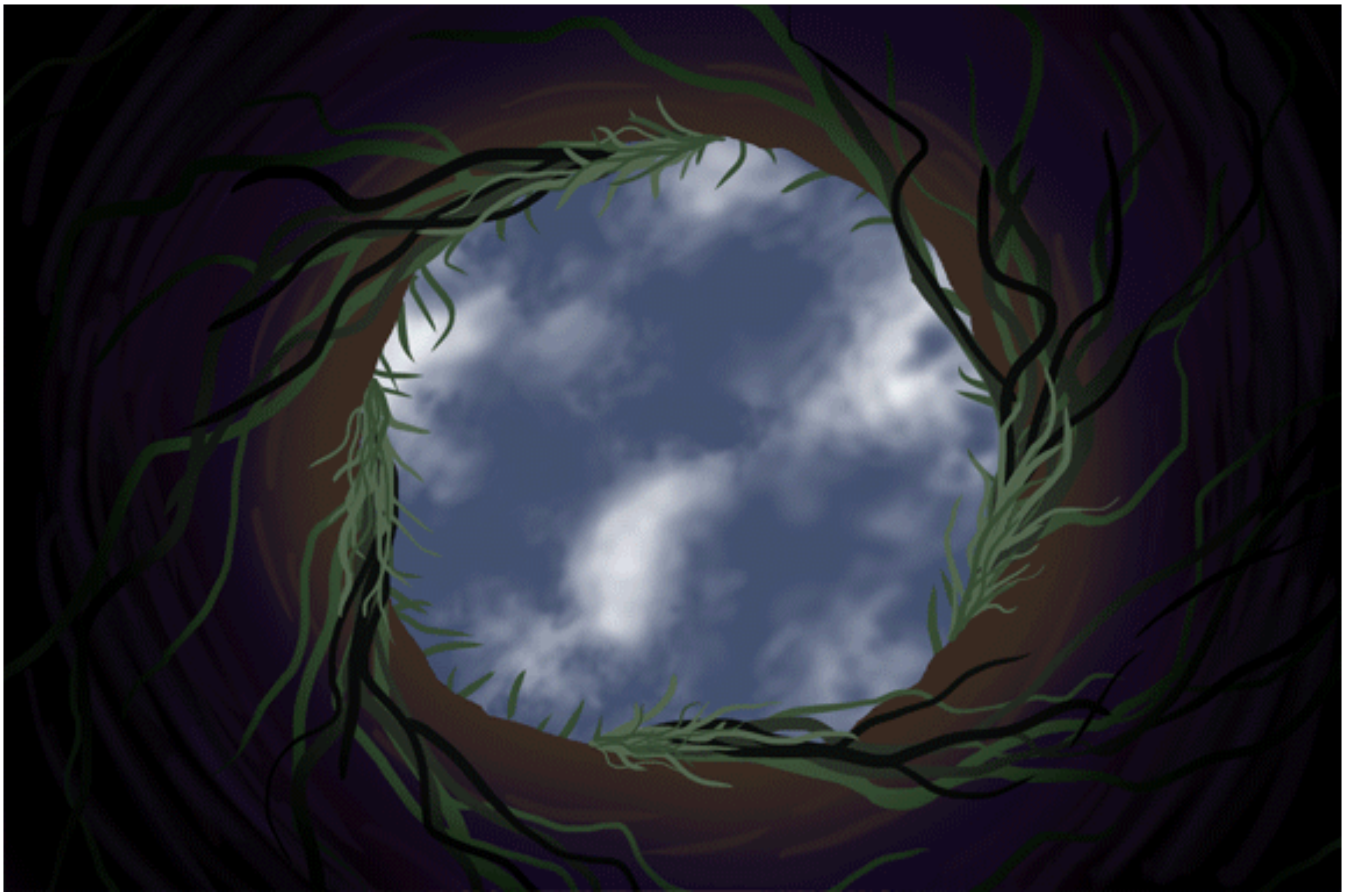
ESG Investing

As promised, this week we are going to dive deeper into one the hottest areas of the market, Environmental, Social, and Governance (ESG) strategies. The big picture theme of ESG investing is doing well financially by investing alongside those who are doing good by the earth, society, and companies where the 'greater good' is a management consideration. The wheel below shows how the Forum for Sustainable and Responsible Investing looks at the ESG world.



To put a little more structure around the narrative, we are going to lean on Blackrock, the worlds largest asset manager, and one that has a lot to gain by getting it right. In their infinite investing and marketing wisdom, they separate the space into four baskets; thematic, impact, ESG, and screened investing. We are going to blend the two as we take you down the ESG rabbit hole.

What Just Happened?

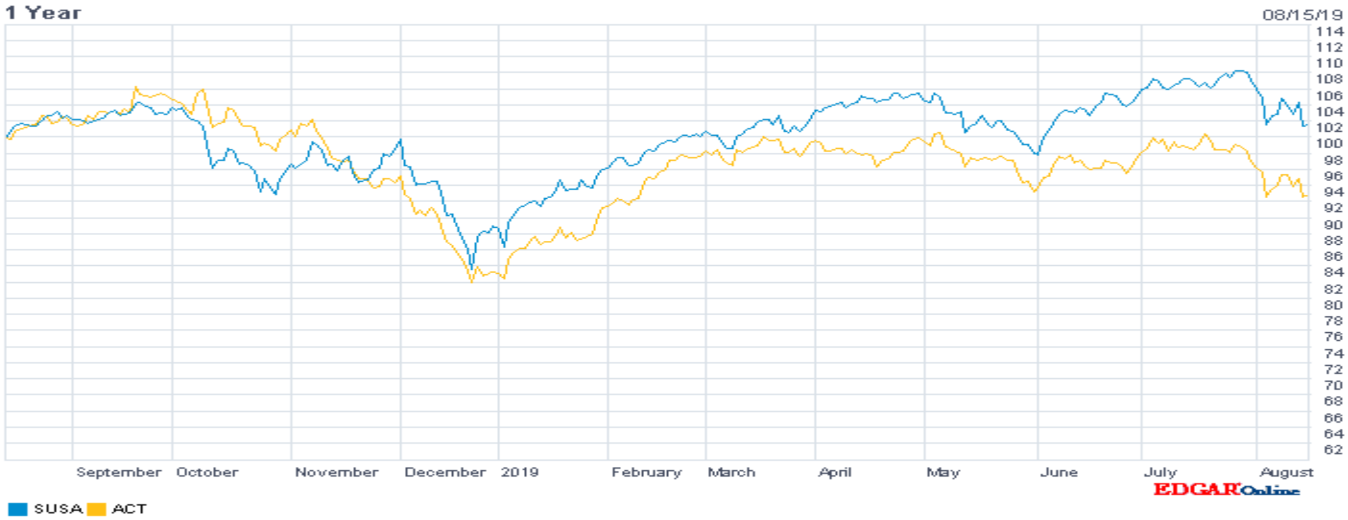


Source: gifr.com

To begin with, let's go back to the beginning. ESG version 1.0 was predicated on the exclusion of certain companies and industries that investors, particularly religious endowments, didn't want in the portfolio because of their 'negative' impact on society. These included gun manufacturers, alcohol producers, certain chemical companies, tobacco, and gambling, to name a few. In 2017, the investment bank Schroders, produced a lengthy white paper on the subject of exclusion. The same year CNBC sat down with Sharon French, the head of ESG at Oppenheimer, to discuss the divergent approaches that were emerging in the space. This year Goldman's head of ETF Capital Markets, Steve Sachs, explains why today's market for ESG goes beyond exclusion.

This week, Vanguard needed to boot 29 stocks out of their funds that embrace this kind of structure of ESG. And because fund companies can't help themselves, Advisor Shares have created a vice ETF where 50% of revenues of companies included need to come from alcohol, tobacco or cannabis. To show how this ETF's performance compares to a socially conscious one, we use iShares SUSA.

Good > Evil



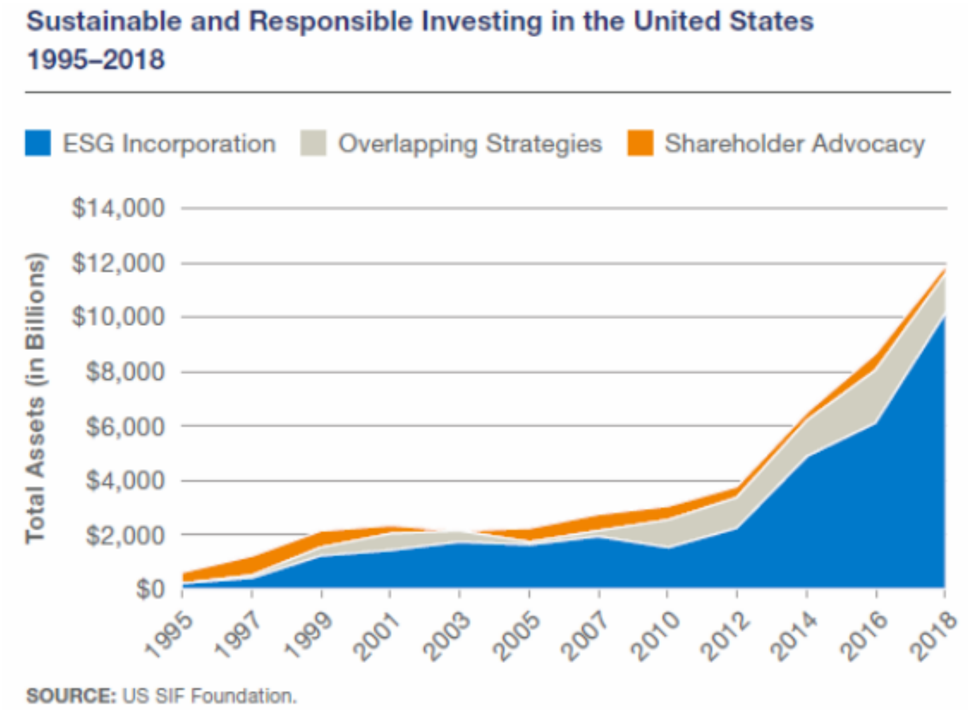
If we fast forward from the 1990's to the early-2000's, ESG began to involve inclusion alongside exclusion. When the author was at Nuveen, working for their affiliate Santa Barbara Asset Management, we would develop new products. I was in charge of liquid alts, specifically long/short equity.

Another colleague of mine was in charge of developing what would come to be called EcoLogic. At this point, the model had changed and now the screen for why a stock was in the portfolio became more important. That said, when the same colleague would go on a road show to describe the strategy, it was only a matter of time before every advisor and due diligence analyst would pick off a name for the egregious offense of having one of out of a total of fifty factories in the dirtiest city in China.

Baoding, China

Source: CNN

Move ahead another few years to 2010, and you start to get into the modern era for ESG. As we've talked about before, Wall Street loves a new theme, especially when there are decent fees behind it and a theme that is easily embraced. And what couldn't be more widely embraced than doing well by doing good. Keep in mind, the metrics for inclusion and exclusion were all pretty much the same, so ultimately success during this phase came down to the branding and distribution.



Since we worked there and also got jobbed out of a perfectly fine track record on a long/short mutual fund, we feel like we can pick on our former shop Nuveen just a little bit. The firm has a series of wildly successful mutual funds and ETFs that have captured billions in ESG assets, good on them for that. Where it gets interesting is when you pop the hood and realize that some of these are simply glorified index funds, with an ESG wrapper around them. Not that doing so is a bad thing, it's simply par for the course in an industry that likes its sizzle and could sometimes care less about the steak.

Medium Rare?

Source: Food.com

This brings us to our current market for ESG strategies and the money behind them. There are now massive pools of money grabbing the thematic model of impactful global investing designed to not only be profitable, but to also advance the cause. Al Gore has put his name, and Rolodex, behind the $22 billion generation investment management. Their goal?

- Deliver outstanding investment results that will that will also achieve the goal of providing the business case for Sustainable Capitalism.

The Texas Pacific Group, TPG, also recently closed a $2 billion fund, and in conjunction released their 2019 GES Report that deep dives into what their criteria for investing will be, and how returns will be judged beyond adding to IRR. And by deep, we mean really deep.

The report includes three portfolio examples: LLamsoft, Beautycounter, and CLEAREsult. If you have spare time this weekend, and an interest in the evolving world of ESG, grab an iced tea and give the report some attention. If you are on a caffeinated roll, take some time to look at the Rise Fund, a collaboration between TPG and global A-listers like Bono, to create a way to truly measure the impact of impact investing.

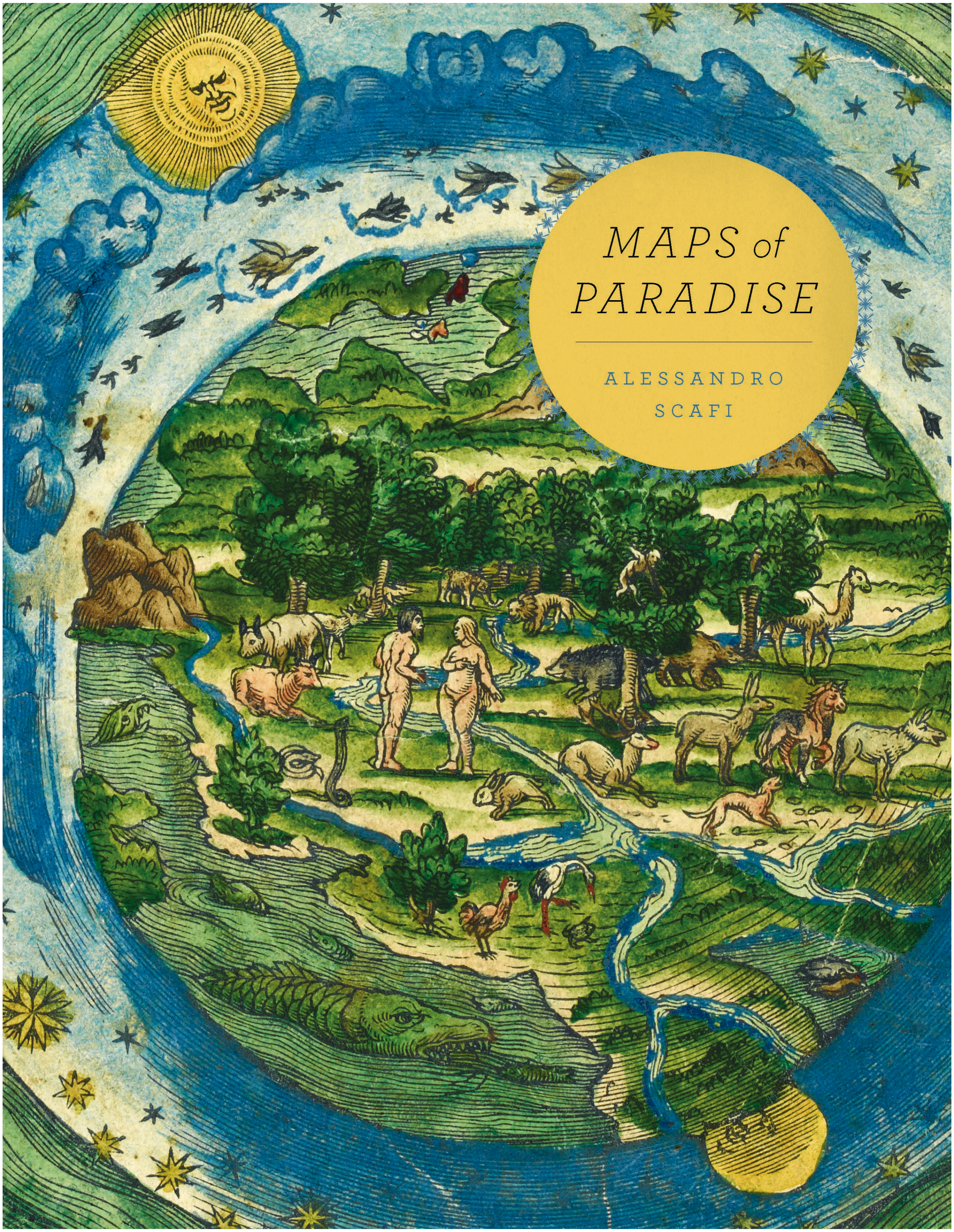
Rise Up

Source: The Rise Fund

And with that we conclude our thirty year look back on where socially responsible investing first started, and where ESG stands today. While retail dollars keep flowing into well marketed products, these are heavily created by quant screens and provide for you an index like return. No great shakes, though it does give investors the peace of mind thinking they are doing good with their dollars.

From our perspective, the true future for ESG lies in far more institutional style, and concentrated, investing. The reason being, a direct investment in an emerging rural bank in India that finances clean water projects and finances ways to get people off single stroke engines, is truly impactful as opposed to owning another share of Nestle because it's a water company. Because that type of granularity requires the human analysis and touch, there is once again a place for active management. May we all find our very own investment paradise

May We All Find Our Own


MAPS of
PARADISE
ALESSANDRO
SCAFI

Diversions

Even the *Diversions* section gets some time off during the summer. But don't worry, it will be back next week with an irreverent look at college football, things you can send your kids off to college with that will make others say 'WTF', and a look forward to what you can expect from September through the end of the year. Trust us, you'll like it all.