The Change Up…

Stillwater had every intention of bringing you the 2020 asset class roundup and preview this week, but our plans changed as we are now headed to New York City and think that time spent in the financial capital of the world provides a better vantage point to opine than the tough streets of Santa Barbara.

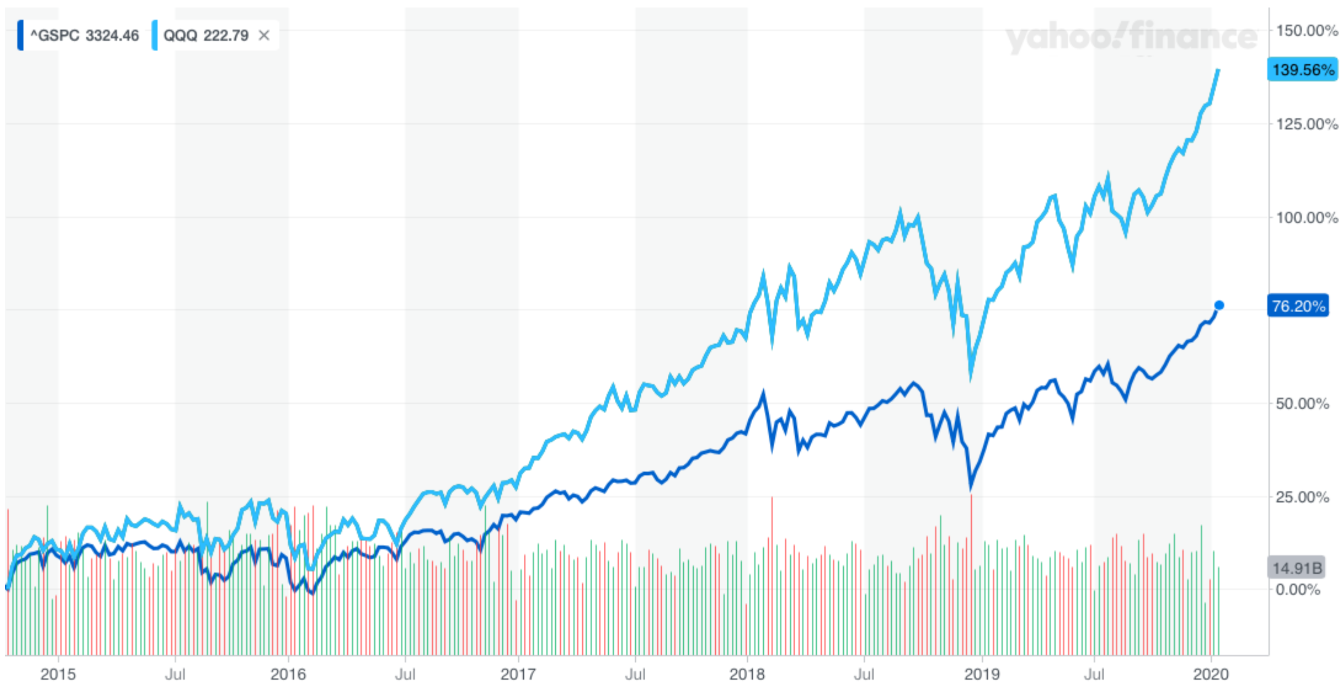
With that in mind, if you are a client, advisor, or potential partner, and are interested in hearing first-hand what we are seeing and doing, please reach out by e-mailing us at contact@stillcap.com and we will work our calendar and arrange to spend time together.

Full disclosure, before you read on, and because we are headed to New York for marketing purposes this week, we will be more promotional of our work than usual, especially on the short side. This is the exception to our general rule of keeping these pages reasonably commercial free. That said, this is a for profit enterprise, and if we don't talk our book from time to time, who will? Thanks, as always, for your continued support of our firm and that goal. Onward.

Markets

The markets are wasting no time in continuing to climb at the torrid pace they finished off last year, with the S&P 500 now up 3% on the year, and the Nasdaq 4% in twenty days' time. Annualize those out, and you get a year-end target return of 36% and 48%, respectively. Best of luck finding a short position that can be held onto in this kind of a melt-up environment. Yet every day we come in and look for such luck and wind up finding some.

S&P 500 v. Nasdaq



In what we would have previously called a bizarre signing ceremony at the White House, President Trump and China's Liu He sat down to put pen to paper on what is described as phase one of a longer-term trade deal. We say bizarre, because on top of a 75-minute ramble, Donald Trump went looking for Ken Griffin who wasn't even at the event. Even though this particular package looks to be light on substance, the markets didn't care, as all deals are considered good deals in this environment. Going forward, look for a lot of jawboning the market higher from the White House, while nothing is likely to get done until after the fall election, as both sides continue to play a bigger game of global trade chicken.

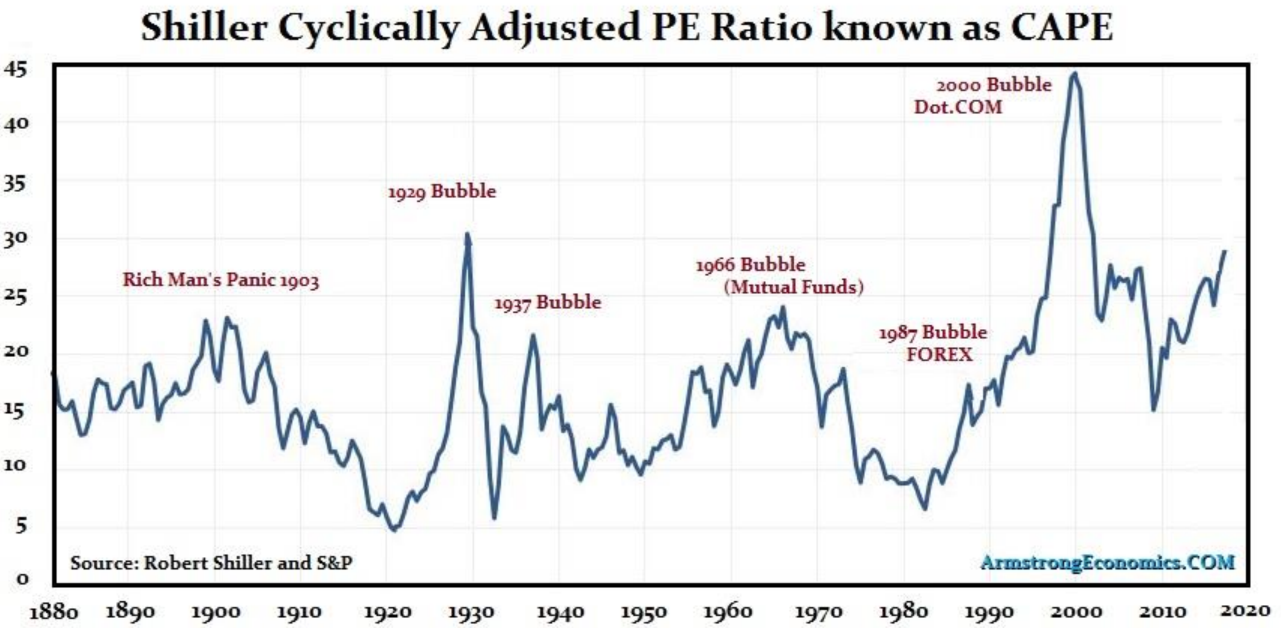
'Momentous Step'

Two hedge fund luminaries said they continue to be long and strong this market, even though both admit to it being 'long in the tooth'. First up, there is David Tepper, founder of Appaloosa Management, who 'loves riding a horse that's running'. His thesis? You guessed it. The Fed has the markets back and that's tough to beat. Another legend, Stan Drukenmiller, said essentially the same thing by fully banking on the Fed. He too used the horse analogy, saying that he was 'still riding' one. This after leaving two-thirds of last year's market move on the table. To which we ask, are these really horses to be ridden, or Jerome Powell induced sparkly unicorns?

My Little Ponies

Full disclosure, we run conservative hedged portfolios who want to participate in the market, but don't expect 'one to one' participation in a straight up environment. For a year and three quarters, we did our job better than most, providing 125% of the S&P 500 return with 50% or less the dollar exposure. When things took off at the start of the fourth quarter of last year, the backdrop changed, and now valuations are challenged. History has shown this expensive of a market doesn't tend to last forever. But as Keynes said, they can last longer than you can stay solvent.

Pushing Thirty



All of this makes us a position player that performs well in a volatile, lower return environment. Our teammates, namely inexpensive Beta and specialty long only funds, are now the ones putting up the big numbers, as they should be. Both score points, one with three yards and a cloud of dust, the other in long passing routes down the sideline. In deference to our favorite team in the NFL, and one of our favorite players of all time, if you are going to be a bruising fullback, be a good one. Go Niners!

Number 44, Tom Rathman

Financial Sector Earnings

Just like those one hit wonders David & David sang, it's 'Welcome to the Boomtown' in terms of (most) bank and financial earnings right now. We say most, as it very much appears that the rich are getting richer, and the poor poorer, unless of course you are short Wells Fargo, in which case you are getting richer while those long the stock are getting poorer. Which of course is a modest way of saying that we are short WFC shares, and have been on and off for a while. Once again, the company put up mixed earnings with another huge legal bill attached, assuming $1.5 billion is a lot of money. Bottom line, if you are a bank and want customers to trust you, don't open fake accounts for them. Seems reasonable, right?

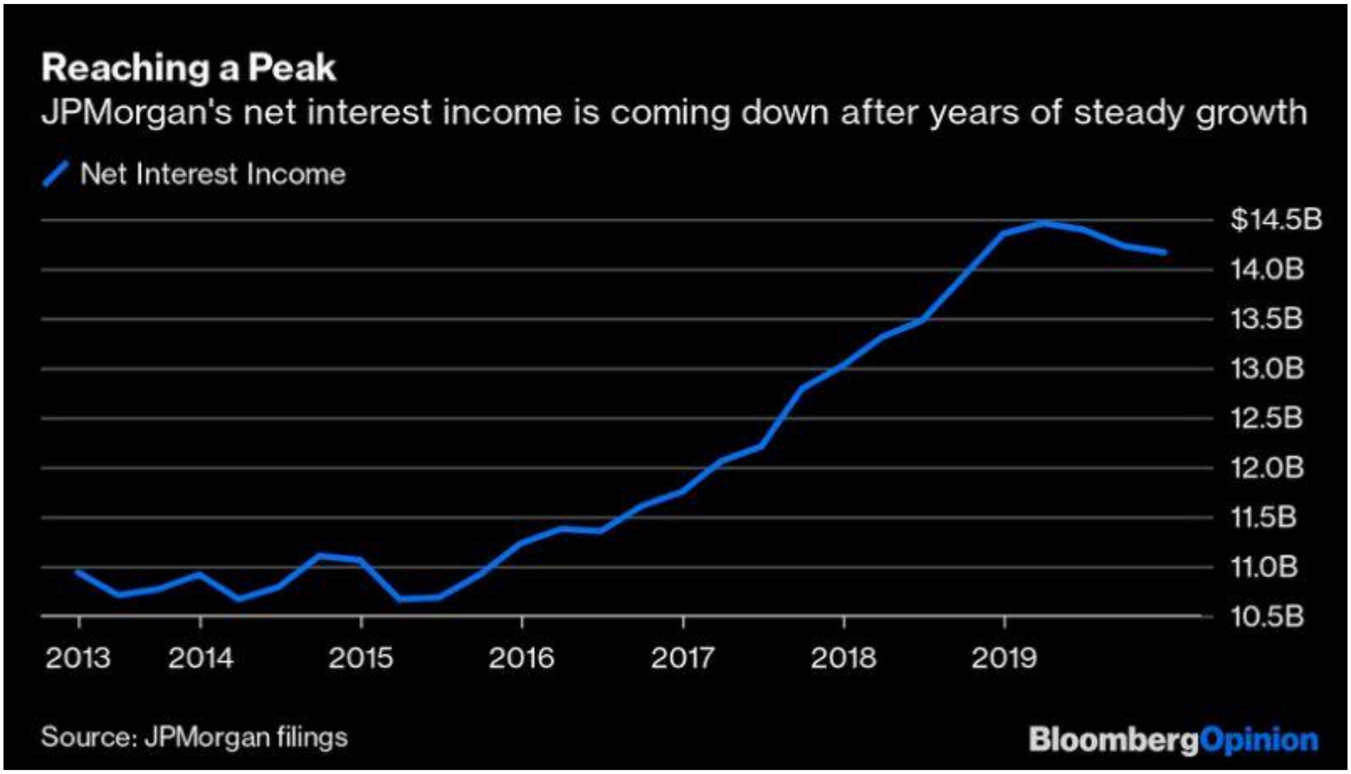
Wells Fargo v. S&P 500

While Wells was struggling, Morgan Stanley and J.P. Morgan were doing just the opposite, as was Bank of America to a lesser extent. For Morgan and the other Morgan, there was a pickup in earnings related to trading and investment banking, while BofA suffered a bit by having to pay out client's higher interest on deposits. Which in this case, doesn't take much given the sheer volume of dollars sitting at the bank founded as the Bank of Italy in the North Beach section of San Francisco by A.P. Giannini. America, what a country!

Bank of America's Origins

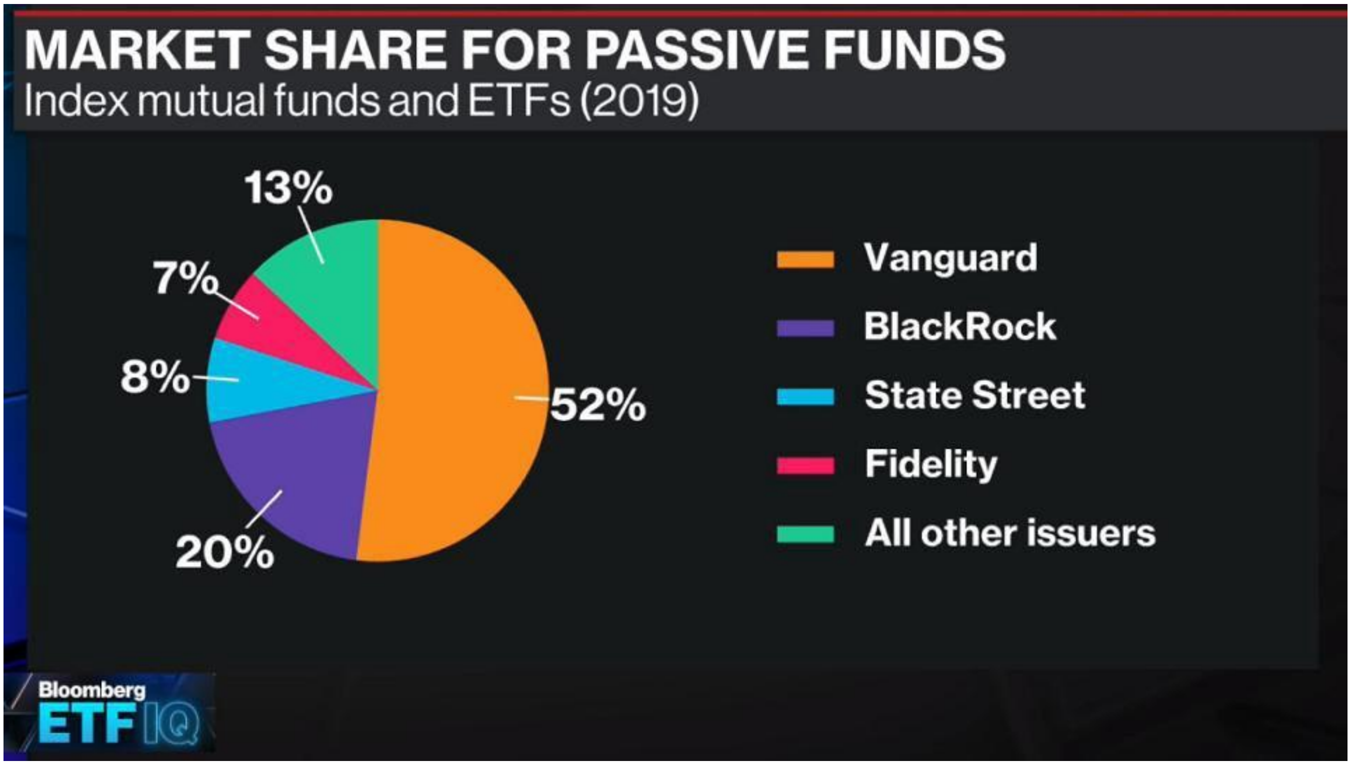
Back to J.P Morgan for a moment, one of the key drivers to bank earnings and expansion of their book value, assuming that's where the cash winds up, is net interest income or margin. The way to increase this stat is to 'borrow short and lend long'. By long and short, we are talking about interest rates. To do this, banks need an upward sloping yield curve. Because if it costs the same to lend two years out as it does to borrow ten, NIM gets pressured, as it has at most banks, Morgan included. Yet the bank has made up the difference on volume over the last decade. Kudos to Jaime Dimon for that.

Is This the Top?



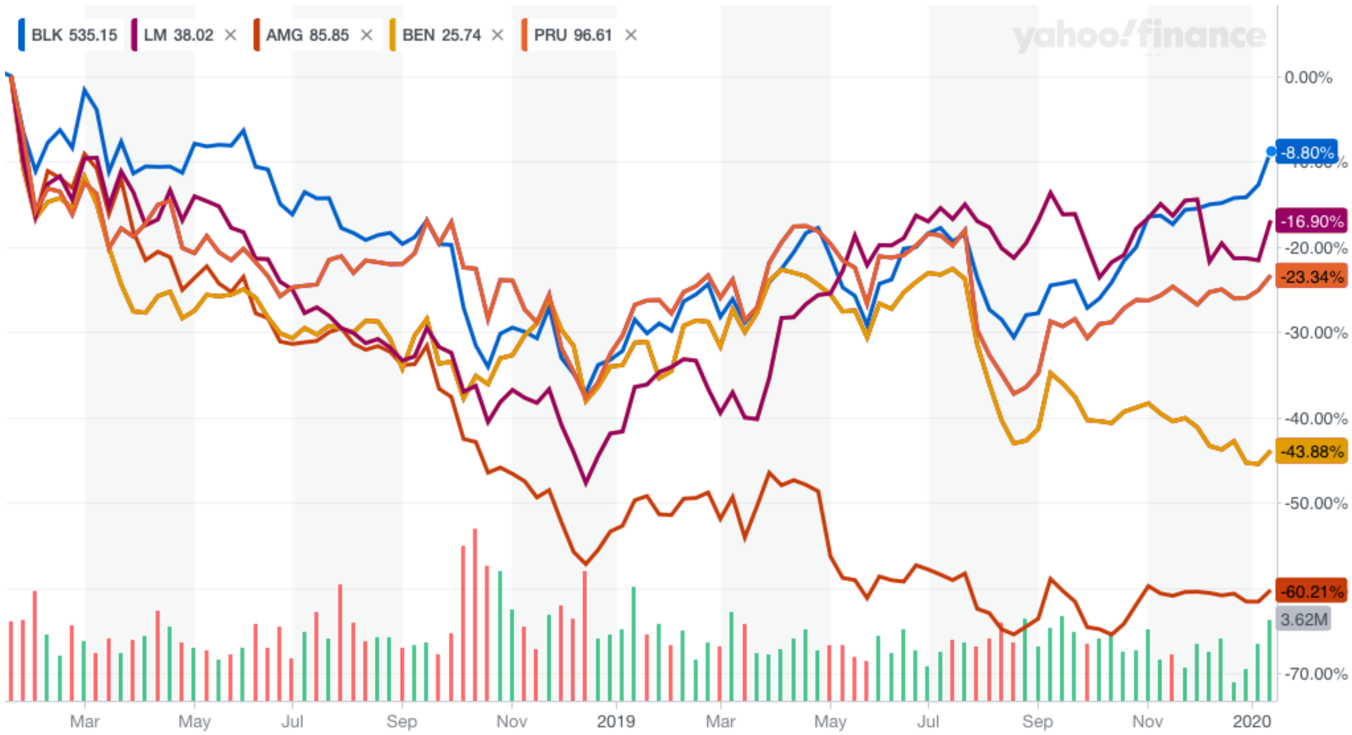
Our wrap-up of financial earnings this week has us focused on the 'death star' of ETFs, appropriately named BlackRock. This week, the world's largest asset manager did what the hip kids like to call, crushed it. For the first time, assets crossed over the $7 trillion mark. This was due to a combination of $500 billion in inflows, and through the appreciation of existing assets. While the company runs a distant second to Vanguard, 20% of $4 trillion is still a lot of money.

A Big Bucket



Which takes us to one of our best paired trade ideas of the last couple of years, and that is a long position in the aforementioned BlackRock, with a basket of short positions in asset managers more reliant on fees from actively managed products. Included on that list are Legg Mason, Prudential Financial, Franklin-Templeton, and Affiliated Managers. Aside from a spike in the shares of Legg on an activist stake taken by Nelson Peltz, this has been a pretty good trade so far. For Peltz, love is hopefully better the second time around.

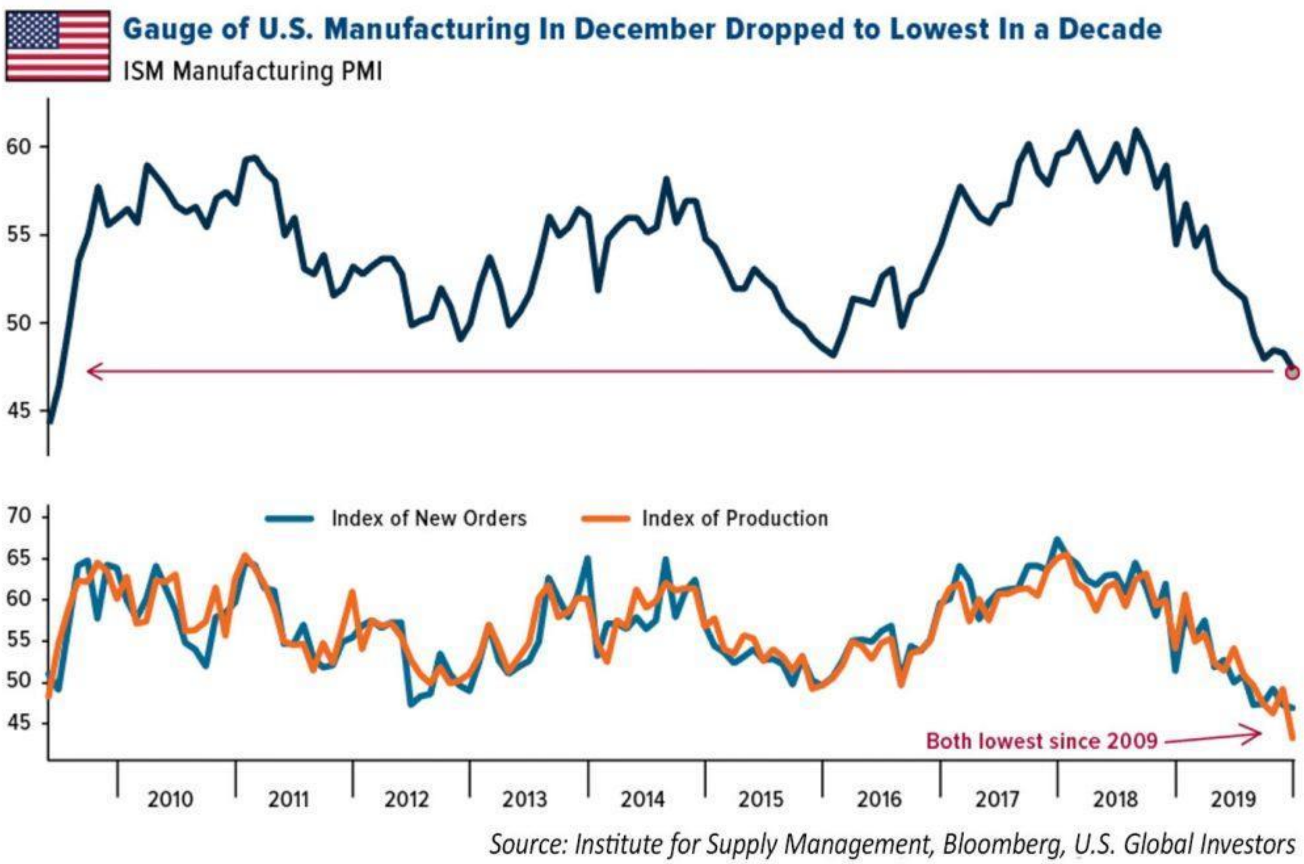
Pretty Paired Picture



The Economy

The economic calendar was downright empty of anything worth reporting this past week, which is becoming more of a trend even with traditionally reliable barometers for growth. The most recent indicator to fall out of relevant favor is the ISM Manufacturing Index. As the Wall Street Journal's James Mackintosh wrote a couple of weeks ago regarding the apathy shown for economic markers these days; 'Investors, Revel in Your Ignorance'.

Stocks Don't Blink at This



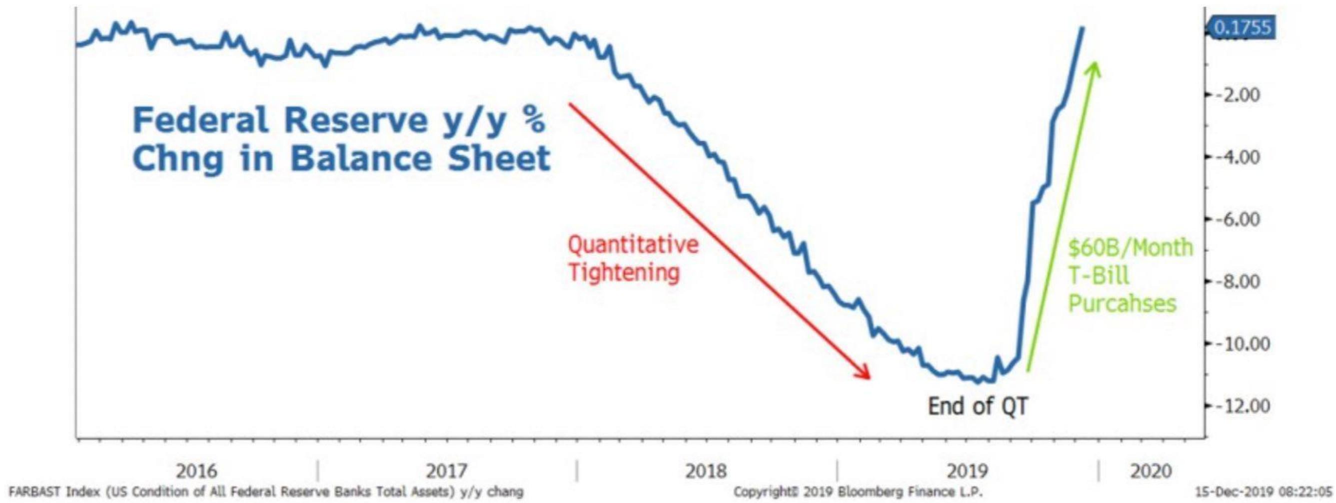
As we said last week, this 'What Me Worry' market has the howitzers of central bankers on its side, and therefore for the last twelve months has taken every bit of bad news and turned it around as an indicator that those cannons are going to be kept fully loaded as long as there is even a hint of trouble. Right now, the only apparent risk is a policy error, and even then, the markets are saying the chances are remote.

Aim, Ready, Fire

Which leads us back to our favorite chart of all right now, and that is the Federal Reserve's balance sheet. This picture is so good, and so pure, in terms of telling the story of who is running the show in this risk-on rally, we might include it every month until the year ends.

The Fed Saves the (Repo) Market

Exhibit 1: Is the Reversal in the Fed's Balance Sheet the Primary Driver of Rally in Risk Assets?

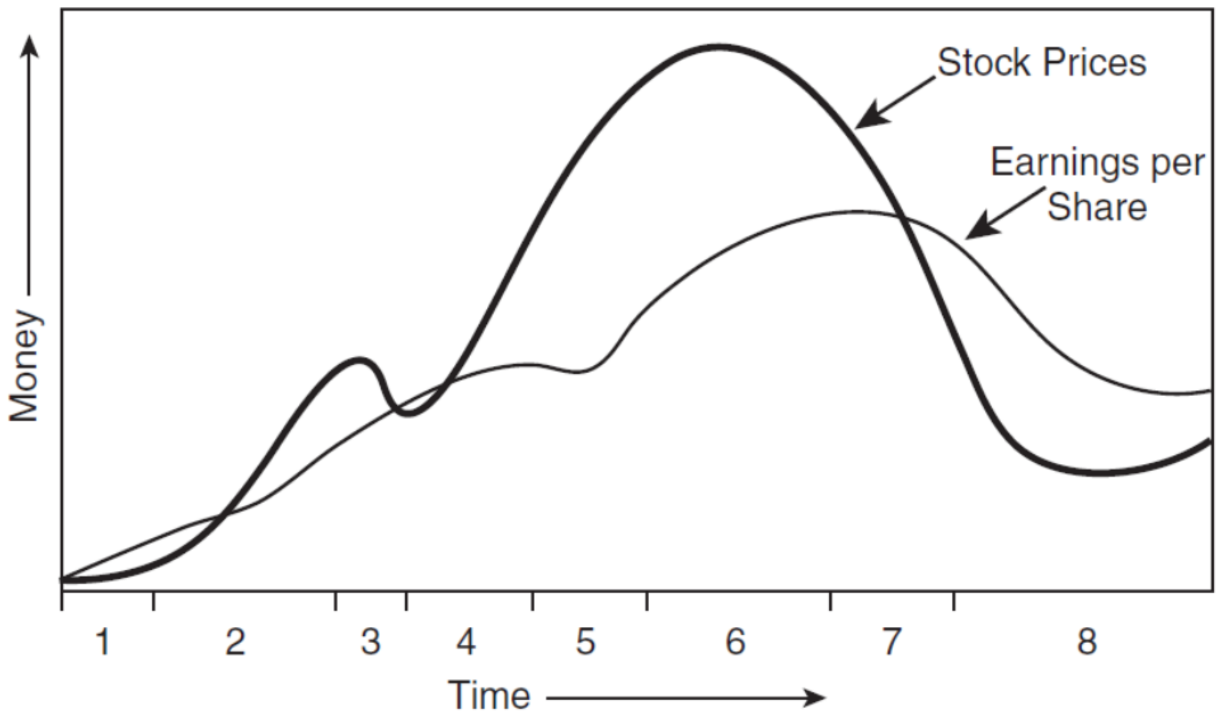


Source: Bloomberg, Morgan Stanley Research

Dallas Fed President Robert Kaplan went on Bloomberg to provide the non-consensus view within the Fed that the move to shore up the repo market is indeed being viewed as QE, and risk assets have responded accordingly.

Which we firmly believe is the case. Remember last week, when we talked about the Theory of Reflexivity and how myth can become reality if enough people believe it? It's on display every day as we ramp higher by another 50 to 100 basis points. From someone who has seen this movie before, it feels like we are at a five or six right now.

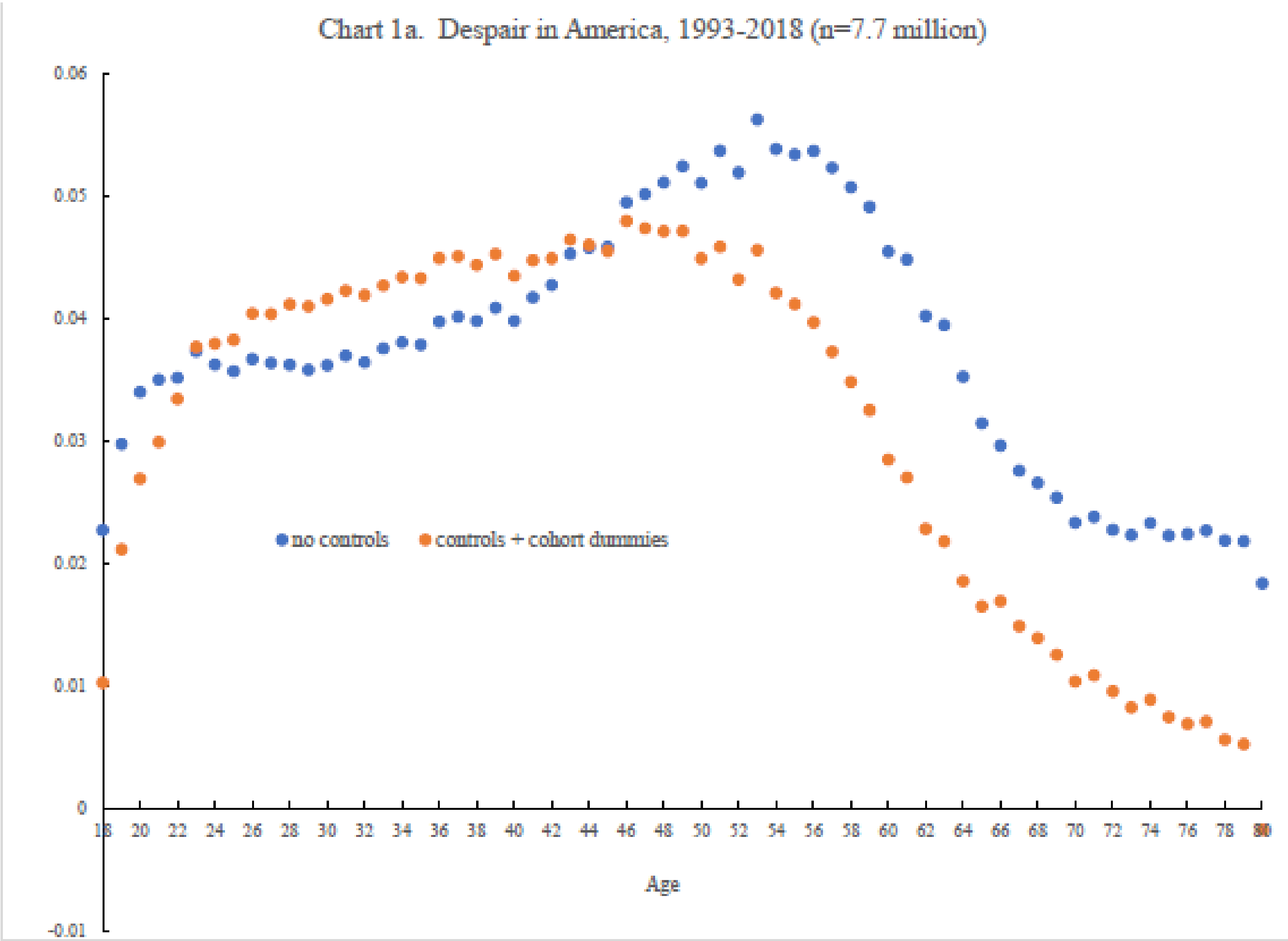
Unconscious De-Coupling



Diversions

A story that got a lot of press this week, was the report out of Dartmouth College and Professor David Blanchflower that found ‘middle age misery’ peaks at 47.2 years of age. Which for those of us on Wall Street who ply our trades in a far less profitable business today can relate to. We joke, because we can. And because psychiatrists tell us it’s normal. But it does make sense from the existential identity crisis perspective, as the social structures we’ve known for half our lives start to change. It’s also nice to know that there is a light at the end of the tunnel, and hopefully it’s not the train coming at us.

Brighter Days Ahead



By the time the day is out on Sunday, we will know who is going to be squaring off in Super Bowl LIV, and for those who don't know their advanced Roman Numerals, that is the 54th. In spite of the challenges Jed York has put before us, we remain loyal to the 49'ers, and still count ourselves as a member of the faithful. Needless to say, we are bullish on Jeff Kerr of CBS Sports take on the 'Five reasons to root for the Niners to win'. Miami will play host, and Super Bowl Sunday is February 2nd. J.Lo and Shakira are your halftime entertainment.

Hard Rock Stadium

That's it for a shortened version of Diversions. Next week we will be brining you an 'outsiders insider view' of the city so great they had to name it twice, New York…New York. We look forward to having you join us again as we travel down this road together.

Bridge to Brooklyn

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