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**Investment Strategy**

## Investment Strategy: "Drill Capital"

I can't quite remember how I met Craig Drill, captain of Drill Capital Management, but meet him I did over a decade ago and we have become kindred spirts. Maybe it's because we both have been in the business a long time, or maybe it is because of our connection to First Boston in a life gone by. Unsurprisingly, Craig is one of the best writers, and investors, on the Street of Dreams. Last Friday he scribed a missive I thought was particularly prescient. The first few paragraphs read like this:

> Despite some recent deceleration, a broad-based global economic expansion rolls on. The International Monetary Fund projects real GDP global growth of 3.9% in both 2018 and 2019. The US is enjoying its second longest economic expansion, and as of July 2019, it will gain the distinction of being the longest. In the aftermath of the 2008 Great Credit Crisis, the strength of this expansion, however, is below average. The output gap has closed. Unemployment is down to a spectacular 3.8%, the lowest since 2000. Inflation is brewing, however. The Federal Open Market Committee (FOMC) indicates it is comfortable with a modest interim overshoot of its 2% long-term target as that would reinforce the "symmetric" nature of the target. There is also hope that productivity will improve on a cyclical basis.
>
> Oil prices, a volatile component of the Consumer Price Index, have contributed to headline inflation. In particular, WTI crude at $67 per barrel has rallied by one-third from its 2017 average of $51. Holding aside political and geopolitical risks, rapid escalation in wage rates and consumer price inflation which would turn the FOMC hostile is the biggest risks to the bull market. Problematic wage rate increases (4%) and troubling core consumer inflation (2.5%) is a concern but is a long way off.

We agree, but would note that inflation is building in the pipeline and tariffs are always, and in every way, inflationary. Indeed, the inflation genie is coming out of the bottle and is best reflected in what is occurring in the trucking industry where pricing is up some 27% YTD. As written in our missive of May 21, 2018:

> In yesterday's Almost Daily Grant's, Jim Grant talked about rising trucking costs and took some quotes from the biweekly Morgan Stanley Truckload Index: "Flatbed capacity is exceedingly tight and will likely tighten further as milder weather finally arrives in northern regions. There seems to be very large imbalances regionally; creating 'panic' freight buying" according to one anonymous shipper. The CFO with Melton Truck Lines said "We have not seen a rate environment like this for a long, long time, if ever." The CEO of Brenny Transportation said "I've never seen anything like this in more than 30 years in business. Volume was at least manageable a year ago. We were doing well and rates were good. But now it's out of control and we can't keep up." She went on to say that last year shippers waited 3 days to get a truck and now are waiting 10-14 days.

Here is the rub, almost NOBODY is positioned for a return of inflation except for us; and while inflation may be as Craig notes "a long way off" it is surely coming. Verily, you can find nowhere in the world where this much money has been poured into an economy and not had inflation come out the other end. We don't think it is any different this time. And to *reductio ad absurdum* the idea of disinflation/deflation, well, you get the idea.

So in my "hit" on Fox last Friday my friend Neil Cavuto interrupted me when I said it is not a trade war, but merely a trade skirmish. He said, "When Mexico puts tariffs on some steel and pipe products, lamps, berries, grapes, apples, cold cuts, pork chops and various cheese products, it sure sounds like a trade war to me." We will concede that if the counter-tariffs mount, it could turn into a trade war, but at this point we continue to think it is just a trade skirmish. Recall that the Smoot Hawley trade war of the 1930s raised tariffs on over 20,000 imported goods. Also know that across the globe there are already over 100,000 tariffs in place. In our opinion this tariff-tiff is not a big deal, at least as of yet.

Moving on to other questions we fielded on Friday, the president's pre-employment tweet at 7:21 a.m., "Looking forward to seeing the employment numbers at 8:30 this morning" drew criticism from many market mavens. In fact, one pundit called

**Please read domestic and foreign disclosure/risk information beginning on page 3 and Analyst Certification on page 4.**

the tweet illegal. While I am not an attorney, the tweet is clearly not illegal, but it was certainly inappropriate. Then there were questions about the stunning employment numbers. As our economist, Scott J. Brown Ph.D., writes:

> An upside surprise for May payrolls, with a +15,000 revision to the two previous months – but that keeps the three-month trend in private-sector payrolls at +178,000 (roughly the same pace as last year). Still, that's enough to further reduce the unemployment rate – something that will worry Fed policymakers. Average hourly earnings rose more than expected, but the year-over-year trend remains moderate. The report is consistent with the Fed raising short-term interest rates again on June 13 (federal funds futures now pointing to about an 80% chance, vs. 70% two days ago and near 100% last week). Bond yields higher (10-year Treasury note yield at 2.92%, up 10 bps). The dollar is mixed.

And then there was this from our pal Leon Tuey as he responded to the headline, "The stock market has done nothing this year." Leon's comments read:

> Above heading reflects the sentiment of most investors today. Bombarded by the endless black headlines, investors continue to fret and sweat fearing that the market will reach new lows. Clearly, these are the professional S&P watchers and know nothing about "the market". Little do they realize that last Friday, the following Advance-Decline Lines hit record highs again: SPX, NDX, MID-CAP, and SMALL-CAP. More importantly, the NYSE Advance-Decline Line Cumulative and the NYSE Common Stock Only Advance-Decline Line also closed at new record highs along with the Cumulative Advancing Volume-Declining Volume Index. These internal measures reveal the real health of the market and are far more informative and hence, more important than the S&P. What these indicators are telling investors is that "the market" bottomed in early February as I've said and the bull market has resumed. Moreover, as the market has yet to register overbought readings and sentiment if far from euphoric, short-term risk is limited and further gains lie ahead. When the major market indices reach new highs, the horses are long out of the gate as they already have.

Plainly, we agree.

**The call for this week:** Our work continues to point to the upside targeting a breakout to new all-time highs. As stated early last week, "The stock market's internal energy returns to favorable levels late week and we think an upside breakout is coming." While I am not *per se* a technical analyst, Andrew is a holder of the Chartered Market Technician designation, and our short/intermediate models are very positive into mid-June with a potential target for the S&P 500 (SPX/2734.62) of 2860 on a trading basis. What is truly amazing to Andrew and I is that pundits who never saw the February Flop coming, and never called the undercut bottoming-low of February 9, are still waxing bearishly, or calling for at best a range bound stock market. Andrew, Leon, and I totally do not see it that way. To that point our research correspondent, Credit Suisse, has released a report of its favorite 30 U.S. investment ideas (call the Equity Advisory Group desk for said report). This morning, with Italy on hold and good news on North Korea, traders should attempt to break stocks out of the 2700-2742 trading range with a leap toward new all-time highs. As we write at 5:37 a.m. the pre-opening S&P 500 futures are better by 12 points.

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