Issue 8

PALOS
INVESTMENT FUNDS

February 22, 2018

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

No Love for the Bank of Nova Scotia

The Bank of Nova Scotia (TSX:BNS) has been significantly underperforming its peers since January 31, 2018. Palos believes this underperformance is primarily due to NAFTA fears. In our view, this fear is overblown and ignores the bank's fundamentals and growth opportunities. If Canadian interest rates continue to rise, banks will benefit from margin expansion. However, higher rates are a double-edged sword. With rising rates, you can expect loan originations to slowdown in Canada. Canadian Banks that have low international exposure will struggle to grow their loan book. In the case of BNS, Palos does not see loan growth being an issue due to its global exposure. Only 52% of BNS's revenue comes from Canada. Palos sees significant growth opportunities globally for BNS, particularly in South America, where the bank is well exposed in Colombia, Peru, Chile, and Mexico. For example, Mexico represents 6% of the banks earnings and has significant room to grow. BNS is also the most sensitive big five bank to rate increases and will benefit the most from higher rates domestically.

Our analysis indicated that BNS's underperformance is unwarranted, especially now that it is trading at significant discount to its larger peers like Royal Bank and TD.

Palos funds have been invested in BNS for many years. However, the price action on BNS has created trading opportunities. The funds have been shorting puts at very lucrative premiums as volatility spiked. Secondly, the funds have taken advantage of the stock's underperformance by going long BNS and shorting the BMO Equal Weight Banks Index (TSX:ZEB)

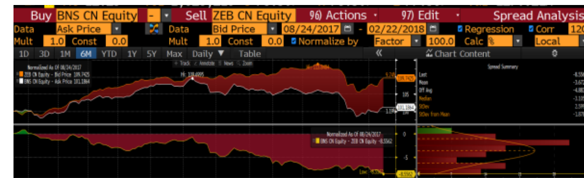

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns)*

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.86	-2.62%
Palos Equity Income Fund - RRSP	PAL 101	$6.51	-2.50%
Palos Merchant Fund L.P. (Dec 29, 2017)	PAL 500	$4.61	15.26%
Palos WP Growth Fund - RRSP	PAL200	$10.11	-5.17%
S&P TSX Composite			-4.03%
S&P 500			1.41%
S&P TSX Venture			-2.52%

Chart 2: Market Data*

	Value
US Government 10-Year	2.92%
Canadian Government 10-Year	2.30%
Crude Oil Spot	US $62.77
Gold Spot	US $1,330.60
US Gov't10-Year/Moody BAA Corp. Spread	166 bps
USD/CAD Exchange Rate Spot	US $0.7871

* Period ending Feb 22, 2018

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■ What is New on the Macro Level?

By Hubert Marleau

The Stock Market

Market turmoil makes us forget why we invest our savings. Ordinary investors are wired to buy well-run publicly traded companies will grow their capital and incomes at a price that is reasonable in absolute and relative terms. They don't mess around with sophisticated financial derivatives and hope to make a buck and outsmart the general market. While the above is how ordinary investors should behave, it remains that they are affected by pullbacks in stock prices and spikes in volatility that may, on surface, appear not to coincide with the fundamental reasons why we actually invest our money. It is important to understand what is going on with market sentiment for can be highly influenced by a changing narrative. As a matter of fact, the 10% market correction that took place in the later days of January and early days of February was triggered by a new rash narrative. A sudden fear that inflation has return from a long dormant episode led to higher bond yields against the backdrop of perceived high-valuation metrics and large bets that volatility would stay low. Given the strong historical connection between inflation and volatility, inflation and bond yields and inflation and valuations, it's understandable that the market became fragile as inflation worries rose. Indeed, the relationships can be severed for the market knows that inflation in a normal setting is the most sensitive of all broad variables. Inflation fluctuates a lot more than other broad economic forces like productivity, employment and growth. We witnessed in a few days the twist and turn of the market.

What is Volatility?

Never in its 25-year history has the VIX Volatility Index been in the spotlight like it has been during the recent market turmoil. The VIX is a gauge which tracks the volatility implied by options on the S&P 500 that is determined by the market prices of all "put" and "call" options on the U.S. stock market index. Calls give investors the right to buy a stock at a pre-agreed price and puts give the owner the right to sell at a pre-agreed price. Thus, S&P 500 options theoretically indicate how far investors believe the stock market might increase or decrease. The VIX is a number that shows by how much participants think that market price will fluctuate. Precisely, a value of 20 means that market players anticipate price fluctuation of 20% over a year. Given that investors have high risk aversion, high volatility is associated with falling stock prices. From emails received from our readers, I was surprised to hear that many investors have little idea about what VIX is. Given its importance, its unbelievable. Again, the VIX is just a number that one cannot buy or sell. But, investors can trade derivative contracts known as futures and options that will pay out based on the value of the index. In other words, the calculated spot value of the VIX has little bearing on the trading of VIX options and futures. The Pro-VIX traders watch the spot value for it numerically aggregates the view of all traders. In this regard it is more likely to affect the decisions of sensitive and nervous investors than harsh speculative traders. That may be why Wall Street calls its the VIX the "Fear Index".

Is Volatility Good for the Market?

It is unnatural to have long periods of serenity in the marketplace. A sudden jump in volatility is disturbing yet a natural and useful to puncture complacency. If capitalism is to function properly, the process of creative destruction must be allowed to function. Capitalism dictates killing off the weakest firms and directs capital to the places where it can make an economic difference. In long periods of market tranquility and moderate inflation, the market loses its ability to perform price discovery as investors tend to direct much of their savings to passive and risk-parity investments. This situation makes no attempt to estimate which stocks are too cheap, and which are too expensive. Secondly, pension funds, life insurance companies and other investors use volatility derivatives to protect their capital and meet their obligations. Thirdly, the conditions must be competitive and free of manipulation so that speculators can provide a fair price to investors and businesses who wish to hedge their financial promises. It is not clear if the market which is used to a favorable environment created by below-normal interest rates is going to be able to adapt to survive in an era ushered in by the ghost of inflation or by the decision to normalize monetary policies.

What is clear is that the phenomenon of an artificially low VIX is an interesting symptom of low inflation; but, more importantly it was central to the market participants, traders, speculators and investors over the last nine years. In a regime where the major central banks effectively underwrite the markets with a "put" to calm financial markets, the VIX indirectly becomes the closest thing there is to the cost of money. For example, when the VIX is low, investors can hedge long equity portfolios with cheap

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insurance. Being able to reduce risk at a low cost because speculators are convinced that moderation is the call of the day acts like loose financial conditions just like easy monetary policy reduce risk with low interest rates. Herein lies the connection, the perception of low inflation means low interest and low volatility. If this is true, then we need to come back to the fundamental question of where inflation is heading. This may be particularly true if we are in a regime change where the central banks may not respond to big slugs of volatility. "Whatever it takes" to calm markets may be out the window. In other words, the famous "central bank put" that provided financial support may be obsolete now that the worry has moved from growth to inflation. The weekly St. Louis Fed Financial Stress Index. which is made up of 18 components, recently spiked-up from a November historical low. The Fed did not interfere. Perhaps it's because financial conditions remain very easy. What is important is that the monetary authorities raised their target range and kept on unwinding the Fed's bond position insisting that the economy is at full employment and the risk is now price stability.

Is There a Pick-up in Inflationary Pressure

There is some evidence in a pickup in inflationary pressure. Recent releases show that producer, import and consumer prices are up as are hourly wage rates. Put simply, inflation is sprouting; but, not everybody is convinced. Going forward, it will become increasingly important to get a fix on inflation. It will be crucial to closely monitor the gold-to-copper ratio, the inflationary expectations versus changes in oil prices, real yields, the yield curve and the weighted average value of the U.S. dollar. It should be noted that changes in these indicators have been very small and it certainly does not look like runaway inflation. The thing is that we do not know if the U.S. economy is operating at full employment or whether there is still a gap between the potential and the actual level of GDP. Consequently, neither the inflationary or non-inflationary narrative has won over the other. The debate is still on as to which thesis will prevail and eventually dominate the thinking of investors. In fact, the market can wildly alter its opinion on macroeconomics. The question, today, is simple. Is economic capacity exhausted?

The inflationary scenario is based on the thesis that the combination of deficit-financed tax cut and spending bills will overheat the already fully-employed economy into an inflationary spiral and worsen the "twin deficits". The recent performance of the dollar supports the argument that the extra spending will find its way into inflation and higher interest rates. The Federal Reserve believes that the "natural" unemployment rate is around 4.5%, well above the actual rate of 4.1%. Moreover, the Congressional Budget Office (CBO) asserts that the current level of GDP - $19.7 trillion - represents full capacity.

The non-inflationary scenario is based on the thesis that the combination of deficit-financed tax cut and spending bills will enhance real economic activity. The measures will increase business capital formation and, in turn, bring more of the working-age population into the labour force and raise productivity. Recent numbers on inflationary expectations supports this argument. The key metrics of inflation-adjusted yields have not broken out of their five-year ranges. Obama's Council of Economic Advisors showed in a white paper that the natural rate of unemployment is much lower than conventional thinking because many who are not in the labour force should be and justice is not given to productivity. In a new paper from the Center on Budget and Policy Priorities' Full Employment Project show that an arguably better estimate of potential GDP is 5% above the forecast of the CBO.

While the inflation-narrative is ahead in the mind of the media, bond investors are not going down without a fight. The real federal funds rate is still negative (Fed Funds minus Core CPI) around 0.50%. That's 150 bps below what is considered the inflection threshold. Bond investors think that the perma-bears who insist on uncontrollable inflation are betting on the suspicion that the economy is exhausted. Indeed, not everybody is convinced that the inflationary scenario will surface as many companies were repurchasing shares en masse. Tracking what drove the decision to buy is tricky, but seasoned investors and sophisticated companies do react to a rotating assortment of signals. When stock prices are near the average price of the last 200 trading days, seasoned investors see the existence of strong technical support. When such a situation is combined with low real rates and a falling forward P/E-to-VIX ratio, those "in the know" tend to bet big on a possible recovery. Goldman Sachs executed share repurchases for clients 4.5 times their average daily volume last week. One cannot be convinced that inflation is about to burst if one keeps on buying the dips. Nevertheless, nerves remain on edge for the VIX index and the Skew Index remains elevated suggesting that the opposite and dueling narrative covered by media headlines is not nailing down a consensus. The

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higher-volatility environment means that 1% stock market swings will become commonplace. The CBOE Volatility Index reached a high of 50.3 on February 6 and a record low of 8.6 last November. Currently, the VIX is about 20.0, down dramatically but certainly not to the level of complacency seen before the correction. A return to normal inflation makes many wonder if the market is capable of a life independent of the "Central Bank Puts". The "Great Moderation" of the past decade when the temperance in both inflation and productivity have dominated the economic landscape. Investors reverted to financial engineering, sophisticated risk-parity strategies and credit architectures making the process of price discovery unnecessary to making money. The moderation period has made bottom-up stock-picking based on crunching the fundamentals of a company non-essential skills to make money. Dispelling the air of unnatural calm may re-introduce the idea that in order to survive the unforgiving nature of the capital markets, investors may have to revert to conventional analysis and revive stock-picking. History shows that sharper market gyrations enable stock pickers to shine and place emphasis upon the quality of active macro-economic and strategic stock picking. It's time to keep calm and carry on. The practice of offering long term opinions about the state of the union on short term market fluctuations is nuts. The Financial Times had an interesting piece on this very point. It wrote "not so long-ago investors were fretting about yield curves flattening. Six months later some are petrified of inflation and the yield curve steepening. Two years ago, U.S. economic growth was not strong enough to justify prevailing equity valuations. Now growth is feared by some to be too strong and the U.S. economy is at risk of boiling over, yet equity valuations are too high. So changeable and dissonant is the market's worldview that if it were a person they would quickly be judged to be at best erratic, and possibly not worth listening to at all."

One should refocus on following a disciplined value-oriented investment process. Price volatility is not a bad thing. It should be welcomed by investors who seek to buy stocks and bonds at bargain prices. Benjamin Graham, the father of value investing, said "simply trying to be less irrational than the mass of speculators who insist on buying after the market advances and selling after it goes down is the way to go." The options market may be a good place to exploit the foolish behaviour of erratic markets. Markets will soon work as they should when normalcies return. In other words, the bond and stock markets will react oppositely to each other. Higher bond yields will bring lower stock prices. Lower stock prices will bring lower bond yields. We believe the market will bias toward higher stock prices rather than lower bond prices. If historical relationships among N-GDP, interest rates and stock averages continue, ten-year bond yields should not rise above the neutral level of 3.50% and, in turn, permit the S&P 500 to head towards 3000. The leverage spread, earning yield less bond yield, is currently 270 bps, above the historical average of 205 bps. Additionally, the expected increase in corporate profits is a natural hedge against rising interest rates.

On Trading Options

Options are full of market information. They can be used to refine one's thinking about the market. Given that uncertainty has returned, the volatility of options will be higher than before but lower than under pure fear. It will probably be an environment of trust and doubt. The Barron came out with a frame of reference to size up where we are and where we might be going. Steven M. Sears thinks that one must understand the Rule of 16 for this simple trick can help traders to separate fact from fiction. "THE RULE OF 16 tells us how options are pricing a stock. If implied volatility—that is the options market thinks will happen in their future—-is 16, it means the stock is priced to move 1% each day until expiration. At 32%, it means a 2% move and so on. You can essentially determine implied volatility by measuring how a stock has traded in the past and estimating how it might move in the future, based on a variety of factors, including interest rates, time to expiration, and events that could move the stock." Theses could be earnings report and related economic and industry data points. The measure is readily available on many online sites. Here comes the gist of the matter. "Doing the simple math to determine if options premiums are cheap or not will lead to an important question. Do you think the security will move more or less than the amount priced by the associated put or call? If you think not, consider selling the options. If you think so, consider buying them". If you don't trade options, use the Rule of 16 to see what the options market is pricing. Steve Sears leaves us with a good piece of advice. "Regardless, do not trade options on stocks you don't want to own". Leave naked volatility trading to the professionals.

If you have any questions about the weekly commentary, the securities that we follow, or investment ideas, please contact us at info@palos.ca