Issue 18

PALOS

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau & Joany Page

Manulife Beats to its Own Drum

Earnings season can be quite a hectic time for many companies. Speculation, headlines and surprising results can drastically move stock prices. This earnings season, we were particularly interested in Manulife's (TSX: MFC) results as there has been a lot of talk lately regarding their long-term care (LTC) business and the new life insurance capital adequacy test or LICAT. Furthermore, Manulife's stock price has been under pressure since January when GE reported losses of US$6.2 billion on its LTC business. The market believed that this could potentially have a very negative readthrough for MFC. After attending a lunch with the company's CFO, however, we were comforted about this risk. He explained that as Manulife reports under IFRS, and not US GAAP like GE, they are obligated to restate their LTC reserves yearly. Therefore, such a monumental loss would not materialize. Manulife was also down about 3% yesterday when one of its US LTC peers reported having unfavourable claim experiences.

Yesterday's earnings contained the strong positive results that reinforced our thesis. Against most expectations, Manulife reported a favourable claims experience for its LTC business and a LICAT capital ratio of 129%, which exceeded the required 120%. This higher ratio is good news because had they not met the requirement, they may have needed to issue new equity. Additionally, their core earnings per share were above expectations and they reported strong growth in most parts of Asia and in Canada.

We believe management is executing on its plan to reduce costs and leverage and increase growth. With its positive results, strong management team, and dividend yield of 3.7%, we continue to believe in the name.

■ Mendel's Option Corner

By Robert Mendel

I was in the kitchen the other week minding my own business trying not to get sucked into anybody's vortex when my daughter the princess comes in and says 'daddy, make me an egg'

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.77	-1.54%
Palos Equity Income Fund - RRSP	PAL 101	$6.44	-2.11%
Palos Merchant Fund L.P. (Dec 29, 2017)	PAL 500	$4.61	15.26%
Palos WP Growth Fund - RRSP	PAL200	$9.44	-11.77%
S&P TSX Composite			-2.69%
S&P 500			-1.06%
S&P TSX Venture			-9.28%

Chart 2: Market Data*

	Value
US Government 10-Year	2.95%
Canadian Government 10-Year	2.33%
Crude Oil Spot	US $68.43
Gold Spot	US $1,313.10
US Gov't10-Year/Moody BAA Corp. Spread	183 bps
USD/CAD Exchange Rate Spot	US $0.7784

* Period ending May 3, 2018

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Now, who can say no to such a heartfelt request? "With cheese," she then says. Yes, cheese! Who doesn't like cheese? And then it occurred to me; isn't Saputo back to price levels not seen in two years?

So I dusted off my pad and paper and got to work and this is what I did the following morning. A classic put selling strategy.

With SAP at $41.27 I sold July 38 puts for $1.60. The return if SAP is above 38 is 4.2% (1.60/38) in 93 days which is 16.5% annualized.
I still have 7.9% stock downside to still generate maximum profit. I have11.8% downside before any loss of capital (41.27-36.40)/41.27
The returns above are non-leveraged.

The bottom line is that I could be wrong by 11.8% on the direction of the stock (which would take it below the 2-year low) and still not lose any money. Now that's not bad.

Of course, my daughter just likes her cheese.

■ What is New on the Macro Level?

By Hubert Marleau

On the U.S. GDP: Q1 2018

The Bureau of Economic Analysis offered a preliminary glance at how the U.S. economy did in the first quarter of 2018. As expected, economic growth eased to 2.3% in the first three months of the year from an annualized expansion of 3.0% registered during the previous nine months. Although the loss of momentum was a bit less than what we anticipated, the economy's upward streak of 3.0% growth is unlikely to be extended for consumers are hunkering down. Consumer spending grew only 1.1% during the March quarter. A legitimate question is how much of the increase take-home pay generated by the tax cuts will get spent as opposed to saved to pay down debt. Interestingly, 3.8% of household personal disposable income was saved compared to 2.6% in the last three months of last year. As a general rule, consumers saved, on average, about 5.0% of their disposable income. What saved the economy from generating an even lower rate of growth was the business sector. Nonresidential fixed capital formation, reflecting business investment in buildings, equipment and software, grew at the annual rate of 6.1%. This segment of the economy has been thriving for twelve months. Not only is business investment a a major reason why the recession risk is low, it is also the key driver of worker productivity, longer-run wage growth and cost push prevention.

It should be noted that we also like think about the economy from the monetary and supply sides. Acknowledging that economic weaknesses usually stem from the effect economic imbalances, we carefully access who bad these are.

On a year over year basis, N-GDP increased 4.8%. Employment growth accounted for 1.6% of the yearly increase while productivity and inflation represented 1.3% and 1.9% respectively. All three factors were among the largest increase registered since the Great Recession. The long-awaited increase in productivity has finally occurred, and it is noticeable. This latter point is remarkable for in economies with low unemployment almost everyone, even the less productive, find jobs.

On a year over year basis, N-GDP increased 4.8%. The transactional money supply with zero maturity increased 4.1% and its turnover rose 0.6%. It was the first increase in the velocity of money in decades. The increase was large enough to suggest that more money is being spent in the physical real world than in the financial sector. It partially explains why long-term interest rates and stock price volatility are up.

The economy did not reveal any serious imbalances. However, both the current account deficit and the budgetary deficit increased noticeably. The former deficit represented 3.1% of N-GDP and the latter one accounted for 4.5%. The twin deficit which adds the budget deficit to the current account deficit was about 7.6% of the N-GDP. That imbalance needs to be watch carefully for its the second largest one witnessed since the end of World War II. It could turn hazardous to the economy if foreign investors were to lose their appetite for U.S. securities and, in turn, to fail to fill the gap while the Fed keeps on rolling off assets. Treasury Secretary Steven Mnuchin said that "by definition supply and demand will equate". He's right but at what level on interest rates? Firstly, the U.S. borrowed $488 billion in Q1 of 2018, exceeding the old record of $483 billion in Q1 of 2010 when the economy was struggling to pull itself out of the financial crisis. According to the CBO, tax and spending measures approved by Congress will push the budget deficit to $804 billion in the current fiscal year, from $665 billion in fiscal 2017, and then surpass $1000 billion by 2020. Secondly, quantitative tightening is gaining momentum for the Fed is buying fewer Treasuries ploughing back

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securities into the bond market. The Fed's hefty balance sheet is $15 billion smaller than it was two years ago. Thirdly, there are reports that investors outside the U.S. are posting less-aggressive bids during Treasury bond auctions. This behaviour has been going on for sometime. Foreign investors currently hold 43% of U.S. government debt, the lowest percentage since November 2016. This proportion has steadily declined from its peak of 55% during the financial crisis. Nevertheless, over the years, foreigners have bought 17% of government auctions. It will be important to please the global investors. Fortunately, there is a sudden realization in the marketplace that the Purchasing Power Parity Rate of the DXY Index, a measure of the U.S. dollar relative price to a basket of foreign currencies, is considerably higher than its forex value at a time when interest rate differentials greatly favour the U.S. capital markets over the rest of the world, U.S.economic growth is superior than in the U.K., E.U., and Japan, and the Fed's monetary stance is more hawkish than that of other major central banks. In the past month, the dollar index rose from 88.75 to 92.75 on Thursday morning indicating willingness on the part of global investors to place bets on the greenback through continued purchases of U.S. securities. Sentiment has cyclically swung in the U.S. dollar's favour for the anomaly between USD and interest rate differential may have come to an end. The foreign exchange market is paying extra attention to the recent recovery in U.S. business investment, the ongoing repatriation of foreign cash, signs of higher productivity, and the prospect of more rate hikes.

Outlook: The U.S Bond Market

Ten-year U.S. Treasuries peaked at 15.85% in September 1981 and the bull run ended in July, 2016 when the yield bottomed at 1.45%. On Thursday, the 10-year treasuries were setting for 2.94%. So far, we did not have a rate shock; but, some analysts think that we may get a bearish shock that would be caused by inflation expectations while others think that we may a get a bullish shock that would be caused by a monetary policy mistake. We think that neither of these two scenarios is likely.

Mean-reversion combined with trailing bond yields rolled over ten years can sometimes give an idea what may happen. That averages out to 2.5% or 44 bps higher than the current level. Interestingly, if bond yields were to mean revert, the upward trend would break. It may very well happen for the current inflation and growth environment is significantly different than what it was in the 70s and 80s. At this point in time, we are not forecasting a breakout in inflation. We acknowledge that the Fed closed in on its elusive 2% inflation target in March. But, there are still enough disinflationary pressures to keep inflation in check. Researchers at Goldman Sachs estimate a 15% probability that core inflation will rise above 2.5% one year from now and a 30% chance two years from now. Greater Fed tolerance for inflation overshoots is possible to temper recession risks, but history is pretty clear that the Fed has limits. There a has been a lot of fuss about the shape of the yield curve because the yield spread between long and short maturities have narrowed creating concerns that the economy might be heading to a protracted consolidation or a recession. While we are aware that inverted yields are good predictors of recession, the chances of having a recession over the next six months is only 12%. In fact, we do not have an inverted yield curve at this time and we may not even get one. In any case, inverted yield curves are dangerous to the economy only when the benchmark rates are above the neutral rate, defined as economic growth associated with stable inflation. Interestingly, the last two Fed appointees, John Williams, president of the New York Fed and Richard Clarida, vice chairman of the Federal Reserve Board, have written several working papers on the appropriate level for the neutral rate. They both agree that the number is much lower than the Fed's 3.00% estimate. Our conjecture is 2.50%. Given the significant importance of their station at the FOMC, it is possible that they may not allow the federal funds rate to rise enough to invert the yield curve. They have come to the same conclusions from different angles which adds substance to their findings. To determine the neutral rate, Clarida compares five and ten year bond yields to find five-year borrowing costs five year in the future. This is how traders estimate of the cost of money outside of the current business cycle. It's a macro model that is robust to regime changes and structural shifts. By contrast, Williams estimate what he calls the natural rate by determining whether the economy is growing above or below its potential. If the economy is too hot, the actual policy rate must have been below its natural rate and if the economy is too cold, the actual policy must be above its natural rates. On Wednesday, the Fed held rates steady, but indicated that there was room to raise rates three more times before hitting the neutral rate. Based our assessment of current financial and economic conditions, we think that the ten-year Treasury yields are range-bound between 2.75% and 3.10%. This is based on the

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notion that we are in the process of returning to a two-plus two economy with productivity accounting for the bulk of the expected increase in real GDP.

What Inflation and Growth Rates Are High Frequency Economic Model Tracking for the Second Quarter of 2018 ?

On May 1, The Atlanta Fed's GDPNOW model estimate for real GDP in the second quarter of of 2018 is 4.1%, unchanged from April 30. The Cleveland Fed's Inflation Nowcasting is suggesting that the Core PCE inflation is currently running at the annual rate of 1.98%.

Technical Perspectives of the Sevens Report (May3, 2018)

1. Despite considerable volatility, the broad uptrend in the S&P 500 remains intact with a key support level at 2569 and a key resistance at 2816. Bullish

2. WTI Crude Oil broke out to a new multi-year high, underscoring the decidedly bullish trend with a key resistant level at $73.43 and key support level at $63.73. Bullish

3. The gold market has been choppy in a largely trendless manner for months with key resistance at $1405 and key support level at $1278. Neutral

4. The 10-year yields hit new multi-year highs, underscoring the decidedly positive trend with key resistance at 3.15% and key support 2.72%

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