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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Cobalt 27 is Streaming Away

On May 22, 2018 Cobalt 27 Capital Corp. (TSX: KBLT) announced a transformational streaming deal. Prior to this deal, KBLT was strictly a hoarder of physical cobalt. The company always had the ambition to invest in cobalt streams. However, cobalt is a rare commodity and most of its production, approximately 65%, comes from the Democratic Republic Congo (DRC). This is not a great jurisdiction for miners. With the Electric Vehicle (EV) revolution, demand for cobalt has risen to the point where there is a cobalt shortage. The majority (99%) of cobalt is mined as a by-product. This makes it difficult for capital to be allocated purely into cobalt. Hence why KBLT is so interesting as a long-term investment.

Not only is KBLT holding 2,982.9 MT of physical cobalt material, the company has now announced a cobalt streaming agreement at the Ramu River Ni-Co Mine in Papua New Guinea (Ramu). This mine is a large scale, long life, low cost asset with 1B lbs of nickel and 100 MM lbs of cobalt in reserves. In addition, the asset has significant resource upside. The asset is managed by the Metallurgical Corporation of China Ltd and has a great track record.

The stream was done via Highlands Pacific (ASX: HIG). Prior to the agreement, HIG owned 8.56% of the Ramu mine. With the $200 million cash investment from KBL, HIG was able to bring its ownership stake to 11.3% and pay back its loan obligations. Palos, sees the deal as mutually beneficial for both companies.

The stream should contribute approximately $29 million of free cash flow. In addition, KBLT is in talks with two other companies that own a 6.44% interest in Ramu. The talks could lead to an additional $110 million streaming agreement.

What makes KBLT an interesting investment is that it is one of the only ways in Canada to invest in a pure play cobalt battery material company with positive free cash flows. In addition, Palos is speculating that KBLT may decide to instate a dividend from this stream. If that is the case, this will attract income investors that want dividends and battery material exposure.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.96	0.43%
Palos Equity Income Fund - RRSP	PAL 101	$6.56	-0.28%
Palos Merchant Fund L.P. (Mar 31, 2018)	PAL 500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL200	$9.54	-10.85%
S&P TSX Composite			0.50%
S&P 500			2.81%
S&P TSX Venture			-8.18%

Chart 2: Market Data*

	Value
US Government 10-Year	2.98%
Canadian Government 10-Year	2.41%
Crude Oil Spot	US $70.67
Gold Spot	US $1,304.00
US Gov't10-Year/Moody BAA Corp. Spread	186 bps
USD/CAD Exchange Rate Spot	US $0.7763

* Period ending May 24, 2018

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

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■ Mendel's Option Corner

By Robert Mendel

I should have just asked my wife where she shops before I opened a JC Penny short put sale.

Betting on a company just because a competitor has reported better than expected earnings can sometimes be hazardous. Take the company above.

On Wednesday May 16, Macy's reported its Q1 2019 numbers that were better than expected. The numbers were much better than consensus expectations, so the stock rallied nicely. Well, if it can happen to Macy's it sure as heck can happen to JC Penny who were set to report a day later after the close.

Perfect, I thought. I will sell some May $3 puts, expiring on Friday May 18. With the stock at $3.07 they were trading at 21 cents which equated to a 7% 2-day return (.21/$3.00). The stock was also much closer to the 52-week low than to the high. The odds were in my favor. Nice. Who wouldn't like that? Ooops, not so fast.

JC Penny reported lower than expected earnings and gave very cautious guidance for the rest of the year. The result? As much as Macy's went up, JCP came down and was going to close below $3 (it closed at $2.61) So now not only was I in the money with my put, but I was also losing money since my break-even was $2.79 ($3.00-.21).

Now several things could have been done. Let's look at each one. First, I could have rolled over to the June 15 $3 puts but that was no good. (I would receive only an additional 4 cents for over 3 weeks.) Had I done so, I would have deferred the issue in the hope that the stock would find some bottom and go back up. In the meantime, by rolling over I would collect more money (premium) in effect lowering my break-even point) The second choice was to take my loss of .18 cents and move on ($2.79-$2.61) but hey that's no fun so I didn't do that either. So I settled on the third choice. For now, I took the stock. I will either sell it after it rises or, if the math is right, will sell calls against my position. We will see what happens, but this is a short-term trade. I will simply move on in the next few days if it doesn't go my way.

I should have just asked my wife….

■ What is New on the Macro Level?

By Hubert Marleau

What's Needed to Spruce up the Canadian Dollar

On Thursday, the Canadian dollar was trading at 77.50 U.S. cents, a discount of 3.0% from our new estimated Purchasing Power Parity Rate of 79.75 U.S. cents. This has occurred in spite of a significant price appreciation in tradable energy products. NAFTA delays, monetary policy divergences and political impasses are creating rough conditions for the Loonie. Consequently, the Canadian dollar will tend to trade below its true value for as long as the negative factors persist.

A Skinny NAFTA is a Possibility

The WSJ reported last week that trade officials missed their self-imposed deadline to wrap up a renegotiated NAFTA. Legislatures in all three countries will have to approve the amended pact which won't be easy in the U.S. with mid-term elections in November and in Mexico with the upcoming presidential and congressional elections. There is now a rising chance that there won't be a deal at all this year. The editorial board of the WSJ reported that "it's a looming debacle" resulting from the failed negotiating strategy of U.S. trade representative Robert Lighthizer. He overplayed his hand with excessive demands and preposterous terms that have political opposition in Mexico, Canada and even in the U.S.. His demands included a $16 minimum wage for Mexican factory workers, the end of international panels to protect U.S. investments abroad, a five-year sunset provision, the introduction of micromanaging of the auto industry and other poison pills. Both Canada and Mexico rejected the U.S. demands for good reasons. The items are anti-competitive, market-distorting, introduce red tape and, in turn, Canada and Mexico called Lighthizer's bluff willing to let NAFTA expire. Nevertheless, the longer it takes to get a new pact, the more likely it is that NAFTA will indeed expire reducing the availability of capital and raising the cost of doing business on the continent, especially in Canada. Canada is a very open-economy greatly depending on free trade and foreign capital to achieve growth and prosperity. Canadian exports and imports account for 40% of the national output of which 75% is U.S. related. Trade troubles would mean layoffs and generations of less income return on capital assets. If something is not done, economic prospects

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could considerably dampen for there is not be enough time to find meaningful alternatives, despite all attempts to do so. It could bring about an annual growth reduction of 0.5% to 1.0% in R-GDP.

Fortunately, we might get lucky as it's rumored in the that Trump is softening his position on NAFTA. Given the threats of retaliation from Japan and Europe over steel tariffs, and from China over trade disputes, President Trump needs a deal to avoid an embarrassing political and economic failure that may turn a Republican Congress into a Democratic one in November. In fact, more than 100 members of Congress have signed a letter to Mr. Lighthizer warning him of the dangers of economic failure. The situation has gotten even more delicate. The Chinese trade delegation walked away from intense negotiations with Washington last week, stating that China could not accept the Trump administration's specific $200 billion cut in the bilateral deficit. Nevertheless, China is willing to undertake measures to create favorable conditions to increase U.S. agriculture and energy exports. Interestingly, the U.S. has put on hold its plan to impose sweeping tariffs on $150 billion worth of Chinese products. Mr. Trump's approach to talks with China is a magnet for criticism as it looks as if the Chinese are winning the trade skirmish. In this regard, U.S. lawmakers are urging the Trump Administration not to walk away from talks on a new NAFTA deal because a deal with neighbours now looks even more important. The Business Roundtable said that it wants the U.S. to remain in the N.A. deal whether it's updated or not. Issuing an intent to withdraw from NAFTA would imperil millions of jobs, create capital write-offs, and reduce the competitiveness of U.S. companies. Wall Street has been publicly vocal that NAFTA was more important than China. House Speaker Paul Ryan responded by extending the notification timeframe to two weeks to pass all legal hurdles. The law was required to fast-track trade deals in a bipartisan way without attempting to force a choice between negative outcomes. He may have felt the pressure from his peers that Trump's ultimatum to withdraw from the pact would be a dangerous negotiating tactic. It could be a hidden sign that a "skinny NAFTA" is in the offing to save face. Several chapters on energy, digital trade, telecom, financial services and technical barriers to trade and customs could be adopted because none of them would need congressional approval since they would not alter U.S. law. It has been reported that some back-sliding is going on. We think that a "skinny NAFTA" could be read as significant victory for Trump and, at the same time, settle a difficult situation. Mexico and Canada reiterated on Tuesday that there is a deal to be had, if President Trump wants one. U.S. Treasury Secretary Steven Mnuchin said that the administration would be open to a skinny deal and willing to wait for a comprehensive NAFTA to settle gaping differences. Separately, the Trump administration is considering slapping tariffs on automobiles imported into the U.S., a move designed to pressure Canada and Mexico to wrap up negotiations quickly over a new NAFTA agreement. The Canadian dollar would likely respond positively to such a skinny / new NAFTA outcome for the Canadian trade account has a surplus only with the U.S..

On Monetary Policy: Divergence Likely to Continue

A central bank is satisfied when there is price stability, a viable balance of payment, full employment and an economy that grows at potential. The Palos Monetary Policy Index takes into account these four main objectives. Currently, the Canadian index is 115.00 --- in an even keel zone. Meanwhile, the U.S. index is around 215.00 --- a zone that dictates tightness. Moreover, the inflation content of the misery index (the inflation plus the unemployment rates) is 38% in the U.S. compared to only 28% in Canada. According to our calculation, the neutral rate in Canada is 2.25% compared to 3.00% in the U.S. These numbers explain why monetary policy in Canada is easier than in the U.S., why the entire yield curve is 50 to 60 bps lower than in the U.S., and why real rates are much lower up north. Not surprisingly, since the end of last year to the end of April, Canadian investment in foreign bonds totaled an estimated $15.5 billion while foreigners sold an estimated $17.5 billion worth of Canadian bonds for a net loss of about $32.0 billion. This was happening as Canada's trade deficit continued to widen. Imports have boomed, showing yearly increase month after month since the end of November 2017. They averaged 6.4%, while exports, on a comparative basis, only managed monthly averages of 0.5%. The situation is putting the bank of Canada in a bind. The state of the economy is asking for easy money while the balance of payment is asking for the opposite. We are under the impression that the Bank of Canada does not care about the deteriorating position of the Canadian balance of payment. They are willing to gamble that the undergoing twist in the labour market where firms are converting part-time workers into full-time will persist. Year-over-year growth in full-time employment has

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accelerated from 0% in late 2016 to 2.6% in April 2018, while part-time employment has decelerated from 5.5% to -2.8%. This dynamic is increasing the total hours worked and, in turn, economic activity. To ensure that this conversion will continue, the central bank must believe that it would be better to keep the system flush to exhaust the pool of part-time workers. Part-time employment accounts for 18.6% of total employment in April, 0.6% higher than the pre-recession level of 2007 --- hence easier money than in the U.S. for another six months. That is about the amount of time needed to attain full potential. In this connection, the Canadian dollar is unlikely to be in a better place, unless the Fed decides to pause its monetary stance soon. The minutes of the May FOMC meeting say that "it would likely be appropriate" for another rate hike soon. Given that the Fed may be willing to tolerate an inflation rate slightly above the 2% target, it seems as if only two more rate hikes are in the offing.

Political Impasses: Cul-de-Sac May Force a Resolution

The Canadian model doesn't work. We can't get along and are therefore unable to solve crucial issues on immigration, interprovincial trade, regulations, etcetera. For instance, the pursuit to get landlock Alberta crude oil to foreign markets is a nightmare. The Northern Gateway and the Energy East projects are dead and the Trans Mountain pipeline is doubtful because of the B.C. Premier John Horgan's attempt to delay or kill it before it spreads. In anger, Alberta premier Rachel Notley points to the pipeline struggle with B.C. as her explanation for skipping the Western Premiers Conference. There is fear in financial circles that there is purposeful neglect and ignorant failure to understand the economic implications of these pipeline blocks on Canadian terms of trade (TOT) and the political ramifications on the Canadian constitution. In income terms, TOT means the purchasing power of exports. In other words, TOT is the relative price of imports in terms of export and therefore defined as the ratio of export prices to import prices. It's an important economic concept. Let's address the trading of oil. Canada was the fourth largest producer of oil in the world and ninth largest consumer. Canada lifted 4.87 million barrels per day in 2017 and consumed 2.41 million barrels per day for a net surplus of 2.46 million barrels per day. Canada sells its oil mainly to the U.S. for a bit less than $60 per barrel. If we had more pipeline, Canadian producers might be able to get the international price of $80 per barrel. Canada is missing out on $25 per barrel on 2.46 million barrels per day, totaling $60 million. On a yearly basis, it means that our terms could be better by $22.0 billion or 27.5 billion in Canadian dollars. That is an astonishing amount that Canadians are letting flow by because we can't co-operate on what would be obviously good for the economy --- enough to pay the cost of the proposed pipelines and conversion to alternative energy. With these kinds of terms of trade, long term offtake agreements to build pipelines become unnecessary and the likelihood of ending with oil stranded assets diminish. A pipeline deal would reinstate some hope that the Canadian model can work and restore some confidence in the long term prospect of the Loonie.

What's Going on Right Now: The U.S

On May 16, the Atlanta Fed's GDPNOW forecasting model estimated that R-GDP in the second quarter of 2018 will be 4.1%, up a bit from the 4.0 % estimate of May 9. On May 24, Moody's high frequency economic model had an estimated growth for Q2 of 3.1%. The Cleveland Fed's Inflation Nowcasting model is suggesting that the Core PCE inflation is currently running at the annual rate of 1.6%. Meanwhile, the Federal Reserve Bank of St-Louis reported on May 24 that it's financial stress index continues to ease, and Moody's Analytics currently calculates that there is only a 12% chance that the economy could be in a recession in six months from now, up from 10% in April. Moody's uncertainty policy index increased on trade disputes on May 22. Palos calculated on May 24 that the U.S. neutral rate was 2.85%, 92 bps more than the yield on three-month treasury bills.

What's Going on Right Now: Canada

Moody's high-frequency model projects that Canada's first quarter economic growth will likely be disappointing, advancing at the low annual rate of 1.6% -- no change. Palos calculates that Canada neutral rate is only 2.25%, 100 bps higher than the Bank of Canada benchmark rate of 1.25%. The Canadian dollar was 78 us cents on Thursday morning, less than our estimated purchasing power parity rate of 79.75 us cents, despite strong oil prices. It's mainly about different monetary stances between Canada and the U.S., political impasses and NAFTA delays. On a forex adjusted basis, the Canadian stock market is outperforming the S&P 500---the ratio increased form 435X on March 23 to 460X today.

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Technical Perspectives of the Sevens Report (May 24, 2018)

1. Volatility has lessened and the broad uptrend in the S&P 500 remains intact with a key support level at 2581 and a key resistance at 2816. Bullish since November 7, 2016

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 $67.50. Bullish since October 30, 2017

3. The gold market has been choppy in a largely trendless manner for months with key resistance at $1350 and a key support level at $1250. Neutral since December 4, 2017

4. The 10-year yields hit new multi-year highs, underscoring the decidedly positive trend with key resistance at 3.20% and key support 2.87%. Bullish since January 8, 2018

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