Issue 23

PALOS

June 7, 2018

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Palos Weekly Commentary

■ Palos Funds
By Charles Marleau

Time to Surf the Whitecap

The recent strength in oil prices and weakness in the Canadian dollar has solidified Palos' thesis that many of the Canadian energy names remain undervalued. The one that stands out is Whitecap Resources (TSX: WCP). This company has a robust balance sheet, profitable growth, strong management team, and has increase its dividend to 32 cents per year equating to a 3.48% yield. WCP also has one of the lowest decline rates in the sector at approximately 20%.

Moreover, WCP is growing via its Cardium assets. Its production growth could end up substantially higher than what the company is forecasting, especially at $85 CAD dollar oil.

WCP's stock price has recently decoupled from its peers. The company currently trades at 6.2x 2018 EV/DACF as compared to it's historical three-year average rate of 8.0x and its peers trading at 7.5x. Palos believes that the recent price action is coming from misinformed hedge funds that believe that the company will be making a large acquisition. Palos had the chance to meet management on June 7, 2018 and we have been reassured that no stock issuance for an acquisition is in the pipeline for the next 24 months.

WCP price swings have created a great investment opportunity. The chart below shows a correlation between WCP and XEG, the Canadian energy ETF, over the past 6 months. When a company with a strong balance sheet and good fundamentals starts to trade below its peers in the energy sector, pair trades offer a compelling way to capitalize on the opportunity without increasing sector exposure. Palos has initiated the pair trade position.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$10.02	1.02%
Palos Equity Income Fund - RRSP	PAL 101	$6.59	0.17%
Palos Merchant Fund L.P. (Mar 31, 2018)	PAL 500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL200	$9.49	-11.25%
S&P TSX Composite			1.14%
S&P 500			4.51%
S&P TSX Venture			-8.75%

Chart 2: Market Data*

	Value
US Government 10-Year	2.92%
Canadian Government 10-Year	2.28%
Crude Oil Spot	US $65.95
Gold Spot	US $1,296.50
US Gov't10-Year/Moody BAA Corp. Spread	191 bps
USD/CAD Exchange Rate Spot	US $0.7709

* Period ending Jun 7, 2018

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■ Mendel's Option Corner

By Robert Mendel

Sometimes you just say no.

Had I done that with my first girlfriend, I would have saved myself 2 years of listening to her own psychiatric counseling stories.

Boy what a number she was. And speaking of numbers, just because a share price seems right doesn't mean you automatically enter into an option play, especially when selling puts.

Take for example Walmart. The stock after reaching $110 fell to $85, a 23% pullback. It now got my attention. But then they announced the Flipkart acquisition, an online e-commerce play in India which further lowered the stock to $82 to make it even better to look at selling put options. Trouble is, the numbers weren't that great on both the shorter term puts or longer term ones making the risk/reward not worth it. So if I was looking for a good percentage return, this was not the play.

A one month at the money put yielded 1.3%. Even though this is equivalent to a 15.6% per annum return, it still wasn't enough considering the 52-week low of $73 and the state of the market. And a 6 month at the money put yielded 5.6% which equated to 11% per annum. So that was not too interesting either. (Longer term puts will be higher priced but actually offer a lower percentage return)

Discipline is the most important thing. If you need to walk away then do so, even if you like the underlying, in this case Walmart. There are many other investment opportunities to look at. See? My girlfriend did teach me something.

■ What is New on the Macro Level?

By Hubert Marleau

The Global Energy Complex: Prices Squeezed by U.S Shale and OPEC

The Members of OPEC will meet in Vienna on June 22. It will likely be more than just a routine meeting. Given that excess oil inventories have largely been absorbed, the loss of output in Venezuela, new sanctions on Iran, and Brent oil prices trading near $75 a barrel, it's rumored that Russia and Saudi Arabia are about to give in to American and Chinese pressure to boost production and hopefully lower oil prices. Although the Russians revealed that they had no intention to change their production for as long as the current cut-deal holds, it is known that they are plotting a scheme with the Saudis to hammer out terms of a deal to jointly increase their oil production It's our understanding that they are backing a plan to gradually raise the output of OPEC and its allies by 300,000 to 1 million barrels a day. The 2016 OPEC-Russia agreement was a 1.8 million barrel a day cut of production. OPEC and Russia are concerned that higher oil prices could damage the fragile recovery in near-term global demand growth, especially from consumers that are price sensitive with lower disposable income. Traders, barring a supply shock, are speculating that the eleven month rise in oil prices is over. On Thursday, Brent oil was settling for $75 a barrel, nearly 50% higher than a year ago, thanks to a mix of OPEC discipline, geopolitical risk and strong demand. This was 5% off a four-year high. It's a natural correction as the buildup of long bets on crude oil was excessive. In the end, oil prices react to what is going on in physical markets. If the real market points down, the chances are pretty good that oil prices would fall because actual supply does not lie.

Currently, there are several regional areas of oversupply that can't find demand. It kind of make sense, the EIA and IEA are giving warnings that another oversupply is not out of the question for 2018. It's based on the notion that increases in American oil production are so colossal that the U.S. oil output will soon overtake that of Saudi Arabia and Russia. In fact, the difference between U.S. and global oil prices is very wide by historical norms. Global prices are about $10 a barrel higher than the U.S. benchmark. As the global oil glut evaporates, the U.S. is contending with its own supply flood. Spurred by a wave of innovation that transformed oil drilling into a highly efficient industrial process, U.S. oil producers have been able to lower cost and boost output. Depressed oil prices and higher production will eventually ripple through the global market forcing major oil producers to lower their prices to compete, especially if the U.S. continues to build infrastructure capacity to send crude to the ocean coasts for shipping outside the U.S.. For example, Alaska LNG is an ambitious $45 billion project to bring gas from the North Slope to the south of the state and liquefy it for export. In an open market, commodities should sell at about the same price just about anywhere. It could unleash another wave of supply in the global market at a time when there are signs that Chinese demand for crude is poised to slow down. The overall demand trend of the industrial and transport sectors (which account for 70% of Chinese oil demand) looks uncertain. It appears

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that growth rates in freight traffic and electricity production peaked at 12% in the third quarter of 2017 to about 6% right now. Moreover, China's inventories, including strategic reserves and commercial stocks, have risen to 930 million barrels, up 130 million barrels in past year according to oil-data company Ursa Space Systems Inc.

New Oil Geopolitics

The rise of shale explains why Moscow is graduating to a more integrated decision-making role, alongside OPEC's de facto leader, Saudi Arabia, in determining how the cartel meters to sway oil prices when they think that prices are too low or too high. Clearly, this cannot be much fun for the U.S. because it changes the game. For decades, the U.S. has relied on the Saudis to steer OPEC. It will no longer be able to easily coax the Saudis to keep prices stable. Now, OPEC plans to institutionalize future deals with Russia, not exactly a trusting partner of the U.S., to reassert itself. The new oil-policy of cooperation between Russia and Saudi Arabia is adding a new layer of uncertainty. Daniel Yergin, "eminence grise of the oil market", said that "the U.S. Secretary of Energy can't give the signal and regulate output the way Saudi and Russian leaders can." The Kingdom of Arabia, Kuwait, Russia and the UAE are the only players who have the spare capacity and ability to respond quickly to market conditions. These players respond much faster than hundreds of private companies spread from Texas to North Dakota. Little wonder that the U.S. administration is pushing for more domestic production and wants new sanctions on Iran, a clear enemy of Saudi Arabia, in order to keep some remaining influence. Indeed, Bloomberg reported that the U.S. government has quietly asked Saudi Arabia to persuade OPEC to raise oil production by 1 million barrels a day. The effectiveness of Saudi Arabia to control oil prices is awesome when spare capacity around the world is low, geopolitical risk is high, and oil shocks are possible. While in the short-term more oil is welcome, a long term risk is apparent since Russian influence in the Middle East could undermine that of the U.S.. Frank Verrastro of The Energy and National Security Program at the Center for Strategic and International Studies in Washington said that "Russia...was really kind of rebuffed from the Middle East because the U.S. was a large presence there and now, because of Syria, Iran and OPEC meetings, the Russians are everywhere." It will become imperative for the U.S. to have a continental energy policy that will incorporate both Mexico and Canada for national security purposes.

The Energy Complex: A Forecaster of Economic Growth

It is crucial to keep a close eye on the oil market, even though the relationship between oil and growth is a not linear. It should be noted that the global oil complex is viable when oil price is near the $55 marginal cost of production. According to a recent note from the Economist, it makes a big difference to Canada, if the price of oil $50 or $100 a barrel. The swing on GDP growth can range from minus 0.25% to plus 0.50%. Unfortunately, it can be dangerous to rashly predict whether oil prices will tumble down or lurch-up. Since I'm not one of those clever hedge fund people who claims a capability to predict anything, let along volatile oil prices, I prefer to deal with estimated equilibrium prices, marginal costs, neutral metrics, or intrinsic values as these help one make reasonable judgements as to whether the price of any given variable is far away from where it ought to be and find explanations as why market prices do not reflect fair value from time to time.

There are other reasons why investors should trace oil prices. Its global importance as the main source of world energy to the all-important transportation industry, its effect on economic activity must be reckoned with. Spikes in oil prices have preceded five of the last six recessions. James Hamilton of the University of California suggests that a rapid oil price increase is a strong predictor of economic downturns. Rapid oil price increases have preceded 10 of the 11 U.S. business cycle peaks since World war II; only in 1970, 1973, and 2003, during or in the immediate aftermath of recessions, did a run-up in prices fail to herald the peak. The latest rise, which has oil prices increasing 100% since the 2016 production cut was signed, is the biggest increase in 70 years. It is smaller than previous rises and, thus, the price rise does not constitute an oil shock. Where prices are below their previous peak, any increase can be classified as a return to norm. If oil prices were to continue to move towards $100 a barrel, global inflation would rise and economic growth would stagger producing stagflation. What is interesting is that oil shocks act independently without assistance from other signals. Oil shocks are prophets of slowing growth and/or recessions. It begs the questions as whether the recent surge in the price of oil is over or not. There is a debate going on as to what is more likely, $50 or $100 oil. According to a poll of 12 investment banks

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surveyed by the WSJ, West Texas Intermediate, the U.S. standard, should average nearly $66 a barrel in 2018, roughly $11 above the marginal cost of production and $4 below the expected Brent average of $70. The WTI price range of the 12 surveyed investment banks is $55 to $75. Our take is that the current price may be the right price since there is no overall shortage of supply and no overall imbalance of demand. If shortfalls in production like in Venezuela are met with higher output from the continuing shale revolution, then the price run-up is due to politics and is not going away. Hedge funds may think that they know more about the oil market than the commercial and professional interests and be willing to trade oil for as much as $10 a barrel above the baseline price of $55 a barrel.

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

On June 6, the Atlanta Fed's GDPNOW forecasting model estimated that R-GDP in the second quarter of 2018 will be up 4.5 %, a small decrease from the last estimate. GDP growth for the second quarter is expected to show some improvement in productivity, the economy's long missing ingredient. The Cleveland Fed's Inflation Nowcasting model is suggesting that the Core PCE inflation is currently running at the annual rate of 1.9%, up from 1.6% two weeks ago. The Federal Reserve Bank of St-Louis reported on June 6 that its financial stress index continues to ease, and Moody's Analytics currently calculates that there is a 16% chance that the economy could be in a recession six months from now, up from 12 % in May. Interestingly, Moody's uncertainty policy index is stable despite many trade disputes. Palos calculated on June 6 that the U.S. neutral rate was 2.81%, 88 bps more than the yield on three-month treasury bills, 3 hikes for an inverted yield curve.

What's Going on Right Now: Canada

Canada's first quarter economic growth was very disappointing, advancing at the low annual rate of 1.3%. We expected 1.6%. On a comparative basis, inflation rose at an annualized rate of only 1.2%. Should later numbers persist, we could see long term bond yields below 2.00%. Expectations for the second quarter are better. We could perhaps see 2.5% because April exports rose to record highs, significantly above expectations. Canada's merchandise trade deficit narrowed in April to $1.90 billion from $3.40 billion in March. Palos now calculates that Canada neutral rate is 2.15%, up from 2.00% last week, and 90 bps higher than the Bank of Canada's benchmark rate of 1.25%. This means that if the Bank of Canada was to hike the policy rate three times, we would face a possible recession. The Canadian dollar was 77.22 U.S. cents on Thursday morning, less than our estimated purchasing power parity rate of 79.75 U.S. cents. The Loonie is not faring well. There is a division of opinion as to whether the Bank of Canada will increase its policy rate in July. Palos believes that current economic data does not support a rate hike. On a forex adjusted basis, the Canadian stock market has outperformed the S&P 500, the ratio increased from 435X on March 23 to 451X today. Loonie weakness is having a dragging effect.

Technical Perspectives of the Sevens Report (June 7, 2018)

1. Reduced volatility is helping the broad uptrend in the S&P 500 with a key support level at 2630 and a key resistance at 2816. Bullish since November 7, 2016

2. WTI Crude Oil recently broke out to some new multi-year highs, underscoring the decidedly bullish trend with a key resistant level at $70.54 and key support level at $60.33. Bullish since October 30, 2017

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

4. The recent decline in bond yields has stopped the 10-year bond yields are decidedly in a positive trend with key resistance at 3.11 % and key support 2.73%. 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