Issue 24

PALOS

June 14, 2018

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■Portfolio Management & Advisors

Charles Marleau, CIM
CEO & Senior Portfolio Manager

Noah Billick
President, Wealth Management

Hubert Marleau
Economist & Co-Founder

Wakeham Pilot
Chairman, Wealth Management

Robert Mendel
Senior Portfolio Manager & Options Strategist

Joany Pagé
Associate Portfolio Manager

Evan Weiser
Junior Analyst

Karim Rhoualem
Financial Analyst

■Contacts

Palos
1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada
T. +1 (514) 397-0188 F. +1 (514) 397-0199
www.palos.ca

Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

The Puzzling Canadian Oil and Gas Market

It seems like all the money is pilling into one name and ignoring the rest of the market. Suncor Energy Inc (TSX: SU) appears to be the flavour of the quarter. this attraction to SU, however, has pushed its valuation well above that of its peers. Palos believes there are good reasons why SU is attracting investors money. It is fully integrated, well positioned to get best price for its commodity, and has exposure to the refinery business. However, SU's multiple in comparison to the larger cap producers is getting rich, especially when you compare it to its smaller brother Canadian Natural Resources (TSX: CNQ).

On a 2019 EV/DACF basis, SU is trading at 8x while CNQ is trading at 6.1x. We feel that the spread between SU and CNQ has reached a level, where a switch between SU and CNQ makes sense. Palos is well aware that SU may knock it out of park on the refinery margin. However, we believe that we can also get this exposure via Parkland Fuel (TSX: PKI) , Alimentation Couche-Tard (TSX: ATD.B), and Keyera Corp (TSX: KEY via its Iso-octane business. See bellow for a visual of SU's outperformance compared to its peers.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$10.00	0.80%
Palos Equity Income Fund - RRSP	PAL 101	$6.58	0.04%
Palos Merchant Fund L.P. (Mar 31, 2018)	PAL 500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL200	$9.54	-10.84%
S&P TSX Composite			2.07%
S&P 500			5.02%
S&P TSX Venture			-10.43%

Chart 2: Market Data*

	Value
US Government 10-Year	2.94%
Canadian Government 10-Year	2.27%
Crude Oil Spot	US $67.00
Gold Spot	US $1,301.60
US Gov't10-Year/Moody BAA Corp. Spread	188 bps
USD/CAD Exchange Rate Spot	US $0.7630

* Period ending Jun 14, 2018

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■ Mendel's Option Corner

By Robert Mendel

Sometimes using options is not the primary strategy, but the secondary one. Take for example, participation in stock financings.

My strategy here is to buy an issue and immediately short the stock at a higher price to lock in a profit. The problem, however, is that sometimes you cannot locate a borrow and it is against the rules to short a stock unless you have a reasonable expectation to make settlement. So, when this happens I turn to options.

Take for instance Aphria (APH), a Canadian company that produces, supplies, and sells medical marijuana. On June 6, after the close of the market, it announced a financing where it raised $225 million at $11.85 per share with a closing date of June 28. I participated in the financing but could not find a borrow so I looked to hedge myself by selling call options. With the stock at $12.05 the June 15 $13 call was trading at .25 cents. So, I sold it. While capping myself at $13, I lowered my cost to $11.60 ($11.85-.25 cents). The plan is to sell another option next week after this one expires today to lower my cost even more, assuming the stock is under $13. If it isn't I will have some choices to make, but it will be a good problem to have since it means I am making money.

Now this strategy does not protect my downside completely but my breakeven, as mentioned previously, is now lower. I did look at also buying puts along with selling calls but all that would have done is guarantee a breakeven by June 15, which is no fun. And with the stock trading in a tight range since the financing announcement, I was comfortable selling just the calls and taking a little chance with some exposure.

■ What is New on the Macro Level?

By Hubert Marleau

No Short-Term Recession Risk

At the time of this writing, The Federal Reserve Bank of New York has a yield curve based financial model that puts, at this time, the odds of a U.S. recession in the next 12-month below 10% for a fifth consecutive month. This figure has been holding steady since April. Though this month's level is near the highest since the 2008 financial crisis, it remains sufficiently below the 30% threshold breached in each of the last 7 recessions. The Chicago Fed has a different model that incorporates the National Activity Index and the real federal funds rate with the yields curve. This blended yield curve shows that the probability of a recession in the next 6 months is around 16%. The measure remains well below the 50% critical threshold associated with each of the last seven recessions. According to Moody's model which takes into consideration a multitude of economic variables there are no glaring economic imbalances. Nevertheless, concerns over the economy's balance sheet, conditions in the labour market and inflationary pressures are fermenting. Moody's Analytics is suggesting that the probability that the U.S. economy will fall into a recession in the next six months has increased from a low of 2% last October to 16% today. Moody sees no immediate threat of a recession and will not adopt a recession as a baseline case unless its probability hits 60%.

The above models are reliable for as long as there are no financial market conditions and political uncertainty remains relatively calm. The St. Louis Fed Financial Stress Index has trended higher from minus 1.65 last November to minus 0.90 at the beginning of April. It was at minus 1.09 on June 8. The average value of the index, which began in late 1993, is designed to be zero. Thus, zero is viewed as representing normal financial market conditions. Given that the index is currently negative, the index is suggesting that financial market stress is below average, and therefore all is good on this front. The only fly in the ointment is U.S. economic policy uncertainty that remains elevated due to the complicated dynamics in Washington surrounding the expense of fiscal policy, the possibility of a policy error by the Fed, the potential isolation of national protectionism, disruption of trade policies and looming chance of import boycotts on U.S. goods. Moody's Analytics Policy Uncertainty Index has increased from a low of 70 in November 2017 to 116.3 in the week ended June 8. A critical point has not been reached. Nevertheless, it should not be ignored that further increases s could weigh on financial market conditions, hurt business investments, and reduce exports. So far so good. High frequency economic models are pointing to a robust second quarter for R-GDP.

The Immediate Outlook

The Atlanta Fed's GDPNow model estimate for real GDP growth in the second quarter of 2018 is a whopping 4.6%, it was 4.0 % at the end of April.

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The St. Louis Fed's Real GDP Nowcast is predicting that the R-GDP in the second quarter of 2018 will grow 3.7%

Moody's High Frequency GDP Model is tracking GDP growth for the second quarter of 2018 at 4.0%.

The Cleveland Fed is predicting that PCE inflation will increase at the annual rate of 1.8% during the second quarter of 2018.

The Atlanta Fed's Business Inflation Expectation Survey conducted in late May showed that inflation expectations have stayed around the 2.0% level.

The Longer Term Outlook

Jamie Dimon, CEO of JPMorgan Chase, doesn't see any reason why the nine-year economic recovery will end soon. He said that "we're probably in the sixth inning and it's very possible that you're going to see stronger growth." His point is that in previous cycles, the economy has seen 40% recoveries in less than the nine years it's taken the U.S. to grow 20% this time around. There is much less leverage in the U.S. financial system and U.S. banks are much better capitalized. It's also true that the wealth of U.S. households has topped $100 trillion, unemployment is only 3.8% and there are more job openings than there are unemployed people. Unfortunately, there are still obstacles that economists do not like such as trade disputes, an aging population, and income inequalities. The U.S. is not so strong that it can afford a costly trade fight with its friends, a rolling over in employment growth, and the negative effect of income inequality on consumer spending. What is needed for better advancement is worker productivity since without it the growth path will quickly decelerate, and the inflation path will quickly accelerate. Worker productivity increased 1.3% from a year earlier during the first quarter of 2018, up from minus 0.4% in second quarter of 2016. While this is a respectable trend increase, much more is needed because the average consumer is maxed-out, the potential for more employment growth is exhausting and less monetary help is expected. Business have lately been increasing their investments in making workers more productive because of lower tax rates and federal regulations. From this point on, only productivity can become the key determinant of economic health. The bottom line is that productivity is the only ingredient left that can bring prosperity to workers in the form of higher wages and to corporations in the form of higher profit margins. Productivity keeps inflation in check, helps the economy remain competitive, and prevents the Fed from leaning against the economy. It may still be too early to declare a win, but productivity trends are good and Palos estimates that year-over-year productivity will notch up to 1.6% in the second quarter of 2018. If our projection are right that productivity gains and employment growth will average around 1.5% and 0.5% respectively over the coming years, a return to a two plus two economy is a reasonable base case scenario. We have often written about our optimism for productivity improvements. What differentiates this latest wave from the one that dominated the 90's is the breadth and diversity of innovation and the broader adoption of existing best practices. As the disruptive phase of digitization ends, innovation moves beyond the process of optimization to fundamentally transform business models and alter value chains. Cloud computing, e-commerce, mobile internet, artificial intelligence, machine learning and the internet of things are creating new digital products and features, introducing new ways to deliver goods and services and eliminating red tape. The benefits have only started to materialize at scale in the third quarter of 2016 and this is giving the economy extra runway.

Forecasting the Next Recession

Recessions may be very hard to predict but they have been the main driver of bear stock markets and bullish bond markets. History is clear that equity prices tend to peak about six months before the onset of a recession. They are damaging to stock portfolios since they act as catalysts for valuation multiple corrections and earning contractions. As a rule, recessions are the byproduct of macroeconomic imbalances like overinvestment, overborrowing, overheated labour conditions, or external shocks like rapid rising oil prices, fast deterioration in banking liquidity, policy errors and big geopolitical event. Unfortunately, we do not have an overarching model or theory that accurately explains when, why, or how these imbalances occur. In any case, the sin of omission can be very costly when a recession call is wrong. It's is the single most important reason why investors stay put even when evidence mounts that a recession appears to be imminent. Normally, there is a blow-off rally in the later phase of a long-term bull market in the form of euphoria. Since one cannot accurately model a recession, it's usually better to constantly adjust one's strategy. The market goes from one

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peak to another many times, too many times to call which one is the last one. In this connection, a recession dashboard like the one Guggenheim has developed can be very helpful to assess longer-term risks. Currently, the Guggenheim Recession Probability Model suggests that a recession is not due until mid-2020. John Burns Real Estate gives an 80% chance that the current economic expansion will end by 2021. That is two to three years off, a long enough time to prepare for the next cycle.

It should be noted that: 1) the U.S. economy is not as volatile as it once was, 2) that recoveries are longer and 3) expansions are less powerful than they use to be. From the 1850s through the end of WWII, the average contraction in economic activity was 22% and occurred once every 2.5 years compared to only 2.3% and 5.8 years respectively since 1945. This current expansion has lasted 9 years, with cumulative GDP growth of just 21%. The low growth trajectory and low economic volatility make us confident that the economy can run some more.

What Does the Fed Think?

On the heels of the robust jobs report, creeping inflation and strong growth, the Federal Reserve raised its benchmark overnight lending rate on by 25 bps to 1.875% on Wednesday. The monetary authorities manifested confidence since they overlooked a key source of stress in some of the Global Systemically Important Financial Institutions (GSigfis), dropped crisis-era guidance, were willing reduced monetary support, and disregarded London's Absolute Strategy Research warning that there is a shortage of dollars in the world. In fact, the Fed signaled two more rate hikes in the second half of 2018 and possibly three more next year and one more in 2020. At this point in time, the fed-funds rate is sitting around 1% below what is estimated to be the neutral level of 3.00%. In their judgement, the economy can still run hard over the very short term before returning to Fed's long run projection a two plus two economy (two percent growth and two percent inflation).

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

On June 13, the Atlanta Fed's GDPNOW forecasting model estimated that R-GDP in the second quarter of 2018 will be up 4.6 %, a small increase 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 Atlanta Fed's Business Inflation Expectation is 2.0%. The Federal Reserve Bank of St-Louis reported on June 7 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 in six months from now, up from 12 % in May. Interestingly, Moody's uncertainty policy index is stable despite complicated dynamics. Palos calculated on June 13 that the U.S. neutral rate was 2.83%, 91 bps more than the yield on three-month treasury bills, 4 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 the later number persist, we could see more downside pressure on the Loonie. Expectations for the second quarter are better. Growth could be 2.5% because April exports rose to a record high, 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's neutral rate is 2.15%, 90 bps higher than the Bank of Canada 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 77.00 U.S. cents on Thursday morning, less than our estimated purchasing power parity rate of 79.75 U.S. cents. The Loonie is not doing 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 form 435X on March 23 to 451X today but is still far away from the ratio of 490X at the end of December 2017. Loonie weakness is having a dragging effect on the comparison.

The Global Energy Complex

The International Energy Agency, in its first detailed forecast for 2019, said that new oil output from U.S. shale should be enough to cover growth in world demand, but nations such as Saudi Arabia and Russia may have to boost their production to compensate for losses from some OPEC members. Iranian output could fall by as much as

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900,000 barrels a day and Venezuela, where oil output has already collapsed, could fall another 550,000 barrels a day. Only Saudi Arabia, Russia, Kuwait and the UAE can fill the gap in short order. In this connection, political tension is supporting the $11 extra that producers are getting over their marginal cost of production.

Technical Perspectives of the Sevens Report (June 14, 2018)

1. Reduced volatility is helping the broad uptrend in the S&P 500 with a key support level at 2675 and a key resistance at 2840. Bullish since November 7, 2016

2. WTI Crude Oil recently broke out to 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. Government bond yields are slowly rising with 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