Issue 26

Palos Weekly Commentary

PALOS

June 28, 2018

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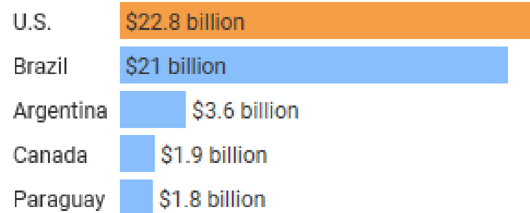
■ Palos Funds

By Charles Marleau

Water & Tariffs Bring Opportunities to Nutrien

In mid June, China decided to fight back after the U.S. slapped tariffs on $50 billion in Chinese imports. China retaliated by raising import duties on tens of billions of dollars of US goods, including soybeans. This is extremely significant as the US is the world's top soybean producer ($23 billion). On the other hand, the largest consumer of soybeans is China ($34 billion).



If the Chinese tariffs move forward, demand for American soybeans will fall and farmers will need to switch crops. Palos believes that American farmers will most likely switch to corn. This potential shift is what got us bullish on nitrogen. A crop of corn needs approximately 137 pounds of nitrogen per acre, compared to zero nitrogen for soybeans. This would significant increase the demand for nitrogen.

Secondly, Palos is hearing that Eurochem is having significant water issues at its Potash mine. If that is the case, production will slow and keep the market much tighter. Potash pricing continues to surprise to the upside and Chinese potash contracts started to be negotiated last week. The preliminary price talks are bullish for Potash prices.

Nutrien (TSX:NTR) derives the majority of its revenues from nitrogen and is significantly exposed to the Potash sector. Moreover, Nutrien announced that it entered into an agreement with Tianqi Lithium Corp to sell its 24% stake in SQM for $4.1 billion. If the Chilean government approves the transaction, this will significantly strengthen Nutrien's balance sheet. This strong balance sheet leads us believe that NTR may go after CF Industries Holding, Inc. If that is the case, we believe this would be strategic and lucrative for Nutrien.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.89	-0.35%
Palos Equity Income Fund - RRSP	PAL 101	$6.53	-0.80%
Palos Merchant Fund L.P. (Mar 31, 2018)	PAL 500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL200	$9.22	-13.86%
S&P TSX Composite			1.29%
S&P 500			2.56%
S&P TSX Venture			-13.22%

Chart 2: Market Data*

	Value
US Government 10-Year	2.84%
Canadian Government 10-Year	2.13%
Crude Oil Spot	US $73.26
Gold Spot	US $1,248.60
US Gov't10-Year/Moody BAA Corp. Spread	198 bps
USD/CAD Exchange Rate Spot	US $0.7537

* Period ending Jun 28, 2018

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■ Mendel's Option Corner

By Robert Mendel

I was making steaks the other night on the barbeque – because that's what I was told to do. It wasn't really so bad though since I was able to get out of the house and away from my aunt Beatrice who apparently hasn't showered in a long time, boy she smells. Now I know why gas masks were invented, but I digress. Oh yeah, where was I? Right, making steaks. So, I was making steaks on the BBQ Monday, spreading spices on it and it got me thinking about conversations I have with people on their approach to selling puts and how they usually fail to follow three simple rules that would reduce risk.

First rule: Spread out your option positions so that all your contracts are not expiring in the same month. Second, never initially sell the maximum dollar amount per position. Third, don't put too much weighting in any one position. Spreading out positions will allow flexibility in rolling over contracts on expiry day especially if a Monday comes along like it did this week where the market, at one point, was down over 400 points. (Rolling over in the money positions when prices are down will not yield as much as it would have had the market stayed up.) Not maximizing your exposure right away will enable you to add more contracts should you wish if a position is not going your way and your premise for opening it is still intact. This is akin to averaging down on a stock. So, if you are ok with a $25k exposure on any stock, start by selling puts for $20k leaving room to increase the position by $5k or 25%. Putting in too much in any one position increases the need to be right on that position, and nobody is right all the time, well, except my friend's wife – but that's his problem.

The rules above are musts if this is to be a successful strategy for you. A must, just like it is for my aunt Beatrice who needs to take a shower.

■ What is New on the Macro Level?

By Hubert Marleau

Every year Credit Suisse publishes a yearbook on global investment returns. Since 1900, real returns net of inflation on global stocks have been 5.2% per year compared to only 2.0% for bonds. It's a wide margin considering that stocks are the riskiest form of capital and can suffer severe damages in periods of war, political upheavals, economic disasters, demand substitutions, demand destructions and corporate corruptions. The premium in performance is, of course, related to the fact that a piece of ownership carries earning power, dividends that are generally produced by advancements in technology, organizational progress and improvement in the methods of production. The bottom line is that bond returns may be safer than stock returns since they are limited to interest payments and principal repayment at maturity. Stock returns may go to zero but they have a significantly higher potential for gains. In academic circles, thos distinction is called the ERP, "Equity Risk Premium". It's a number that we watch daily. For example, the "ERP" was 305 on June 28. It basically means that investors were willing to pay 305 bps above the yield on ten-year treasury note. That is the earning yield (EY) on the S&P 500, 5.88%, less ten-year treasury yields of 2.83%. Risk and return are tied at the hip. This little exercise is useful and practical, but there is no guarantee that the risk taken will bring about a superior rate of return even when the ERP is sky high. There have been episodes where stock losses were so bad that many investors lost their appetite for risk and shunned equities. It's true that the long-term track record of stocks is linear, stock returns are not promises, and none knows what the future holds. Not everybody wants to invest in a faith-based exercise like human talent, ingenuity and the capitalist system. This attitude is a mistake. Daniel Kahneman, winner of the Nobel Prize in Economics, wrote a fascinating book "Thinking, Fast and Slow" and Andrew Lo, an MIT professor, also wrote wonderful book "Adaptive Markets" that are transforming the fields of economics and investing. They are firmly of the opinion that optimism is the engine of capitalism and overconfidence is the curse. Kahneman explains that people who make great things are both overconfident and optimistic, overconfident optimists one might say. They tend to take huge risks because they underestimate how large the risks are. In fact, there are more failures than successes. Indeed, one should not over trust their gut feelings since nothing is worse than to trust one's intuitions when wrong.

Palos enlists technical analysis, not as the only way to analyze the market, but to supplement economic fundamental research and valuation metrics. This helps us base our intuition and judgement on some expertise stemming from experience, research, historical precedents, empirical evidence and valid theories. In this regard, Palos makes use of what we call equilibrium points like the Purchasing Power Parity Rate, Neutral Rate, NAIRU, and the Palos Monetary Policy Index among others. Albeit not an exact science, the rules of technical analysis are

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discernable and can be learned and applied with sufficient reliability to be effectively testable against what we call fundamental valuations, economic factors and financial theories. The bible of technical analysis is "Technical Analysis of the Financial Markets by John Murphy and for beginners "How Technical Analysis Work" by Bruce Kamich. Investopedia says that technical analysis is the study of supply and demand forces as reflected in the market price movements of any tradable instrument that often includes trading volume and open interest figures. It is an attempt to forecast future price movements and current market trends including support and resistance areas. Commonly used technical indicators are trendlines, moving averages, and momentum indicators such as the moving average convergence divergence (MACD) indicator. In terms of charting techniques, Palos likes to look at what most traders understand. These are 50-day and 200-day moving averages, Trend lines up and down, Japanese candlesticks, Advance/decline lines, Price channels, Chart patterns ("head and shoulders", double tops and bottom), Breakouts, Range bounds and Relative Strength Index.

At the most basic level, technical analysis combined with fundamental research can enhance stock market returns. In fact, Christophe Faugere, David Smith and Ying Wang wrote a piece of research in 2014 to demonstrate that "funds using technical analysis appear to have provided a meaningful advantage to their investors." The research shows that institutional funds whose managers say they make use of technical analysis have performed cumulatively better than the majority of funds whose managers say they do not. It makes sense that charting can capture predictable mass behaviour. The behavioural psychologist, Daniel Kahneman, developed the concept of "anchoring." It's based on the notion that if enough people think that technical analysis matters, they will anchor on outcomes that technical analysis deem important and they will become self-fulfilling prophecies. Thus, it is an added tool that can be used to inform decisions to buy, sell or hold securities. The ups and downs of the stock market are, when all said and done, influenced by marginal changes in supply and demand as investors and traders react to information. Without a doubt, decisions are in the charts. By sifting through fundamental economic research, we can measure the various equilibrium points in the economy and studying company's financial statements we can figure out intrinsic values. The hard data becomes a lot more valuable when we use technical analysis to figure out if the fundamental factors are already priced into the market and fit in with stocks. Before we place a bet on any given strategy or stock, we combine fundamental and technical analysis in the hopes of increasing the odds of being right. In this respect, Palos is lucky in that we have the advice of an outsider, the highly respected Leon Tuey, and our in-house specialist Bill Mitchell, a seasoned technical analyst to give our portfolio managers market clues and signals. The takeaway is that technical analysis can often show when certain fundamentals are not expressed in the marketplace and when noise and biases are assuming too much importance. In an article that appeared in the 71st CFA Institute Annual Conference, Daniel Kahneman said that in the world of finance and investment there is too much noise and not enough trustworthy intuition and expertise. He added "an idea adviser is someone who likes you but does not care about your feelings." Nobel laureate Richard H Thaler is such a person, we have Leon and Bill. Kahneman proposes four simple strategies for portfolio managers. These are;

1. Don't trust anybody, trust rules; design as many as you can and construct them for guidance
2. Take the broad view and do not look at problems in isolation.
3. Don't be too risk averted nor too optimistic - find a middle ground
4. Get a wide-ranging perspective to cultivate curiosity and seek out balance advice.

On June 23, Leon Tuey sent me an email telling me that "Canadian Pacific and the Royal Bank, being two highly economy-sensitive stocks were flashing bullish signals suggesting that better times lies ahead for the Canadian stock market setting the stage for a bull run. Technically, the TSX has completed a 10-year base. Technical measuring implications calls for a move to 23800 to 24000 or higher. The magnitude and duration of this base point to much higher levels than the so-called measured move. A secular bull market has begun without doubt. Moreover, there is a good likelihood that from this point forward, the Canadian market will begin to outperform the S&P 500." We think that it has already started. Since February 9, the TSX index is up 8.0% while the S&P 500 index underperformed, increasing only 3.1%. The Loonie is fooling us. On a foreign exchange basis, in a sense, nothing has happened. Taking foreign exchange into consideration, the TSX/S&P ratio has not budged staying at 450x for the period under consideration.

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

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On June 28, 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 high estimate of 4.8% two weeks ago. Macroeconomic Advisers, which runs one of the most sophisticated forecasting models, is tracking a 5.3% growth rate. The GDP is expected to show some serious improvement in productivity, the economy's long missing ingredient. It explains why the U.S. economy is roaring. Despite this robust growth, inflation is where the Fed wants it. 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% three weeks ago and the Atlanta Fed's Business Inflation Expectation is 2.0%.

The growth picture is starting to show cracks. Non-exchange traded industrial materials like rubber and cow hides (that are first on the production line and therefore extra sensitive to changes in business activity) have quicker reflexes and are falling in value diverging from exchange traded goods like oil. On the economic front there are three big factors that could go wrong. First, the sharp narrowing of the trade deficit should be a one-off event before the tariff increases. Second, business investment has not accelerated maybe because of uncertainties associated with ongoing trade disputes. Third, consumers are spending but not saving any money. In fact, the NY Fed has parted from Atlanta Fed and St. Louis Fed predicting that Q2 real growth of 2.9% and 2.6% for Q3.

The Goldman Sachs financial stress index is not at a critical level but has steadily risen for months. Year-over year trends in the money and credit aggregates are running near a low 4.0% annual run rate, delinquencies and redefault problems are clear and present consumer and business confidence is declining, prospective buyers of homes are declining for affordability conditions are worsening and the political uncertainty index is rising. The financial markets are suggesting that the recession chances are creeping up. Moody's Analytics currently calculates that there is a low 16% chance that the economy could be in a recession in six months from now. But, it's still up from 5 % in January.

Palos calculated on June 28 that the U.S. neutral rate was 2.70 %, 78 bps more than the yield on three-month treasury bills, three hikes for a flat yield curve. Copper prices are $2.97 a pound (watch for $2.75) and oil prices have surged to $72.85 (watch for $90 a barrel.) Herein lies the secret as to what could be ahead of us. We are far away from an inverted curve combined with much lower copper prices and much higher oil prices - we shall monitor these market variables closely. We are sticking with our view that the U.S. will print two-plus two economic figures in the forthcoming quarters. That is 2 for growth and 2 for inflation.

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%. On a comparative basis, inflation rose at an annualized rate of only 1.2%. At this time, it looks as if these disappointing numbers will persist into the second quarter of this year. Retail sales are down and so are business and consumer confidence. NAFTA has a lot to do with this prospect. Little wonder that there is little love for our Loonie. Palos calculates that the Canada's neutral rate is now 1.97%, 72 bps higher than the Bank of Canada benchmark rate of 1.25% and 40 bps lower than it was in mid-May. It means that if the Bank of Canada was to hike the policy rate three times, Canadians would face a possible recession. The Canadian dollar was 75.00 U.S. cents on Thursday morning, much less than our revised purchasing power parity rate estimate of 80 U.S. cents. The Loonie is not doing badly. The market thinks that there is 50 % chance that the Bank of Canada will increase its policy rate in July compared to 85% a few weeks ago. Palos believes that current economic data do not support a rate hike.

Nevertheless, we think that it may be a time to chip away at the loonie while it's trading for a 6.25% discount to its PPPR of 80 us cents. The political sentiment is changing all across Canada. Even Quebec is going blue, blue is conservative in Canada like red in the US. Right-of center economic policy is what the doctor should prescribe, lower corporate taxes, faster depreciation rates, less financial and business regulations and freer trade among the provinces. It should be noted that barring an unravelling of NAFTA, the majority of Loonie forecasters are buyers of the Canadian dollar. According to forecasts compiled by Bloomberg, the dollar is poised to end the year at 78 U.S cents by the end of this year and 80.5 us cents by the end of 2019. The forecast is based on the notion that even friends and supporters of Trump are mounting objections to do away with NAFTA, revealing that the cost to business would be too high. Should some agreeable clarity surface over the coming months, the discount should decrease and could

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disappear. Terms of trade are improving with the rise in oil price. The only risk is the dissolution of NAFTA which would be a devastating shock. Such an occurrence would bring about a recession and a 70 U.S. cents Canadian dollar.

The Global Energy Complex

A loose and ambiguous agreement by OPEC members to boost oil output by about 1,000,000 barrels a day partially explains the $17 premium that oil producers are getting over their marginal cost of production and drawdowns in U.S. inventories of oil are reducing the premium to $5.00 that international consumers must pay over the U.S. price of $72.85 per barrel. Since the November 2016 agreement, world inventories have drawn down to the five-year average and hit the lowest levels in three years this year. Given that the Saudis are the only oil producer that have significant spare capacity of 2.02 million barrels, the oil investors feel confident that the global glut that dragged oil prices to $30 a barrel four years ago is not about to return. Indeed, the OPEC/NOPEC decision is not aggressive enough to overcome the expected decline in Iranian and Venezuela oil output and to swing the market back into a surplus position. Declining inventories in the U.S., the syncrude outage and moderate increase in U.S. production is causing, albeit perhaps temporary, a mini-surge in oil prices--$72.85 on thursday morning.

Technical Perspectives of the Sevens Report (June 21, 2018)

1. Increasing volatility has not negatively affective the broad uptrend in the S&P 500 with a key support level at 2675 and a key resistance at 2790. 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 resistance level at $72.13 and key support level at $65.34. Bullish since October 30, 2017.
3. Gold market has been choppy and largely trendless for months, breaking to the downside with key resistance at $1290 and key support level at $1227. Neutral since December 4, 2017.
4. Government bond yields are slowly rising with the 10-year bond yields and are decidedly in a positive trend with a key resistance at 2.96% and a key support 2.73%. Bullish since January 8, 2018. Interestingly, the bond market is not acting as it should, we see two temporary forces at play. One is that many traders fear that the current trade/tariff disputes could stunt growth and two is that speculators think that the dovish ECB meeting will keep wide interest rate differentials in favour of the U.S. If it were not of these two factors which accounts for the strength of the greenback, yields on ten-year treasury would be more like 3.10%.

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