Issue 22

PALOS

May 31, 2018

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Superior is on a Roll

A few weeks ago, Superior Plus Corp (TSX: SPB) announced a very strong Q1, which came in well above consensus. In addition to the strong quarter, on May 30, 2018 SPB announced that they had entered into an agreement to acquire NGL Propane, LLC (NGL) for a total cash consideration of US$900 million. NGL sells propane and distillates to over 316,000 residential, commercial, and industrial customers in the Northeast US. Following the transaction, Superior Plus will be the 2nd largest retail propane distributor in North America. According to management, the merger will bring US$20-25 million dollars of synergies. Palos believes that management is being very conservative. With the acquisition, SPB will reach critical mass where they will become a price giver instead of price takers which should translate to lower costs of goods sold and higher margins.

Palos is looking for management to implement their Canadian playbook in the U.S. and optimize truck utilization with technology. The truck and head count can be lowered as their fleet utilization becomes more efficient. The acquisition is immediately accretive to operating cash flow. On a multiple basis they are paying 8.2x 5-year normalized EBITDA, which is lower than the US Gas MLP distributors that trade around 9x. SPB is using equity and debt to finance the acquisition.

The deal will bring the total leverage of SPB to 3.7x EBITDA, which is on the high side. However, due to the new cash flows from NGL, management sees their debt going to 3.0x by the end of 2020. Palos believes that the debt could also be reduced if the company decides to sell their chemical business. We believe that this is likely as the company becomes a pure play on propane distribution. If management is successful in selling their chemical business, this would give the company dry powder to make tuck in acquisitions. Propane distribution in the US is extremely fragmented which brings large consolidation opportunities.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.96	0.44%
Palos Equity Income Fund - RRSP	PAL 101	$6.56	-0.31%
Palos Merchant Fund L.P. (Mar 31, 2018)	PAL 500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL200	$9.45	-11.69%
S&P TSX Composite			0.25%
S&P 500			2.02%
S&P TSX Venture			-10.22%

Chart 2: Market Data*

	Value
US Government 10-Year	2.86%
Canadian Government 10-Year	2.24%
Crude Oil Spot	US $67.10
Gold Spot	US $1,298.00
US Gov't10-Year/Moody BAA Corp. Spread	190 bps
USD/CAD Exchange Rate Spot	US $0.7717

* Period ending May 31, 2018

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■ Mendel's Option Corner

By Robert Mendel

Surely not everything goes the way you want it. Last week I wrote about JC Penney and how it traded below my strike price forcing me to make a decision.

JCP was intended to be a short-term play, win or lose, since I wasn't comfortable holding this name longer term. My choice was really one of the three I mentioned last week (close it, take it or roll it)

With that in mind, let's look at a Goldman Sachs, a company that I fully intended to ride out if I was wrong. Here in my mind, the only choice was to roll the option. So, with the stock at $145 I sold a $120 put which equated to a 6.5% annual return. I know, not great, but it did come with a 17% downside protection. ($145-$120/$145) And protection was what I wanted.

Immediately the stock headed south. From the outset in May 2011 the stock fell 20%, and at one point was down over 35%. But like I said, I was going to roll the option and I continued to do so a total of 4 times over a year and a bit. And every time I did, I collected more and more premium. At the end of the day, I walked away with a profit even though the stock was still 20% lower. See the chart below. So even though I goofed the entry point, I still made money, not because the stock rallied, but in spite of it. And that is what this strategy is all about. Let the math work for you and may the odds be ever in your favour. (I hear that's some sort of Hunger Games reference, but I have no clue nor do I care)

A Case Study
Goldman Sachs: A Losing Position Turned Winner

Date Open		Security	CR/DR	Net DR/CR	Stock Price when Positioned
May 27, 2011	SP	Aug 120	$1.95 CR	$1.95	$145.00
August 22, 2011	BP	Aug 120	$5.75 DR	-$3.80	$115.00
August 22, 2011	SP	Sept 120	$9.20 CR	$5.40	$115.00
September 13, 2011	BP	Sept 120	$19.00 DR	-$13.60	$101.00
September 13, 2011	SP	Jan 115	$20.00 CR	$6.40	$101.00
January 19, 2012	BP	Jan 115	$11.75 DR	-$5.35	$107.50
January 19, 2012	SP	July 110	$14.25 CR	$8.90	$107.50
June 14, 2012	BP	July 110	$17.15 DR	-$8.25	$94.00
June 14, 2012	SP	Oct 110	$19.20 CR	$10.95	$94.00
September 10, 2012	BP	Oct 110	$1.90 DR	$9.05	$116.00

SP = Selling Puts BP = Buying Puts

*Position closed out with a $9.05 profit per contract even though:

- The stock fell 20% (from 145 to 116)
- The strike price was lowered from 120 to 110

Oh, by the way, I took my loss on JCP of .24 cents selling the shares at $2.55 ($3.00-.21 = 2.79-$2.55 = .24) and moved on…

■ What is New on the Macro Level?

By Hubert Marleau

On U.S. Monetary policy

The minutes of the May FOMC meeting released last week reiterated confidence in inflation stabilizing near the 2.0% target with diminishing downside risks and assurance in expectations of above-potential GDP growth. Consequently, another policy rate hike in June is a certitude. However, the monetary authorities stressed a willingness to allow inflation to exceed the rate of 2% because it has been below the elusive inflation goal for a prolonged period. They noted that a temporary period of inflation modestly above 2% would be consistent with their symmetric inflation objective. It could be, in their judgement, helpful in anchoring long-run expectations at the 2% desired level. Put simply, after the June FOMC meeting, the Fed will have increased the federal funds rate seven times to 1.75% during this normalization cycle. That will about 75 bps away from the estimated neutral rate of 2.50%. Should the rate of inflation stabilize near 2.00% and yields on ten-year treasury notes maintain current levels, the yield curve would be flat, and inflation adjusted interest rates would be positive for the first time in a decade. It makes me wonder if the Fed's apparent dovish tolerance is more about concerns that diminishing accommodation could spell a meaningful growth-slowdown more than about the desire to tolerate higher inflation. Several Fed governors are publicly warning against too many rate hikes. Numerous forecasters are predicting some contraction in economic growth while others are suggesting that inflation expectations remain somewhat low and further normalization may not be necessary to keep inflation in check. As it turns out, it is now more than just a possibility, but a probability, that the tightening stance may change to even keel sooner rather than later. In this connection, the FOMC may begin to show less aggressiveness.

The big question mark is inflation. It's controversial since the outlook is so mixed that it is difficult to discern if the secular deflationary forces will prevail over the inflationary cyclical ones. At this point in time, we are leaning toward the idea that the rate of core inflation will not break out since the factors that brought it down still abound. These factors are outsourcing, de-unionization, technology, globalization, the substitution effect and corporate bargaining power. On May 31, the BLS reported that in April, Core PCE index was up 1.8%. The latest bout of turmoil emanating from Italy, unsolvable trade

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disputes, and reduced world growth outlook is also denting investor confidence that the Fed will continue to tighten its policy later in the year. Activity in options on Eurodollar futures show that traders are starting to unwind bets that the U.S. central bank will hike rates four times in 2018. In fact, the latest market swings suggest that the odds of one more 2018 rate hike after June's anticipated increase have considerably fallen.

In our view, the Fed may become obsessed with the neutral rate concept. The FOMC's leading expert on this notion is the very important NY Fed President John Williams. He has written several serious papers on the subject and is a welcome addition to the Fed. We see no reason why the neutral rate should be raised above 2.50%. Firstly, current demographic and productivity trends are not strong enough to create a lasting above average rebound in economic growth. Secondly, the demand for safe assets is clearly present and strong enough to offset the anticipated shrinkage of the Fed's balance sheet and increase in public debt to keep the term premium in the Government bond market near zero. At this time, we do not have any hints as to why the Fed would enter into a contractionary regime. On the contrary, too many Fed members fear the potential negative outcome of an inverted yield curve produced by a policy rate above the neutral rate.

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

On May 31, the Atlanta Fed's GDPNOW forecasting model estimated that R-GDP in the second quarter of 2018 will be 4.0%, Meanwhile, Moody's high frequency economic model had an estimated growth for Q2 of 3.1%. Macroeconomic advisers are now tracking 3.6% GDP growth for the second quarter with 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 1.6%. The Federal Reserve Bank of St-Louis reported on May 28 that its 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 12 % in May. Interestingly, Moody's uncertainty policy index is stable despite many trade disputes on May 28. Palos calculated on May 31 that the U.S. neutral rate was 2.66%, 76 bps more than the yield on three-month treasury bills.

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 numbers persist, we could see long term bond yields below 2.00%. Palos calculates that Canada's neutral rate is also only 2.00%, 75 bps higher than the Bank of Canada benchmark rate of 1.25%. It means that if the Bank of Canada were to hike the policy rate three times, we would end up in a recession. The Canadian dollar was 77.10 U.S. cents on Thursday morning, less than our estimated purchasing power parity rate of 79.75 U.S. cents. The Loonie fared slightly better in the last few days on the anticipation that the Bank of Canada may increase its policy rate in July. Palos believes that current economic data does not support the expectation. On a forex adjusted basis, the Canadian stock market is outperforming the S&P 500, the ratio increased form 435X on March 23 to 457X today.

The Global Oil Complex

The International Energy Agency stated that "major oil producers largely succeeded in their mission to rebalance the energy market and mop up an oil glut that weighed on crude prices." The WSJ reported that commercial crude stocks in industrialized economies have fallen to their lowest level in three years. OECD oil inventories totaled 2.82 billion barrels in March, 1 million below the latest five-year average metric widely used by oil-market participants to access the rebalancing process. Cracks are showing in the alliance of petroleum producing countries. Moreover, several OPEC members are accusing the Saudis of capitulation to U.S. and Russia pressure. On Thursday morning, West Texas Intermediate futures were trading at $67.80 a barrel, that is about $12 above our estimated marginal cost of $55 a barrel. Yet, Goldman Sachs is maintaining its bullish outlook on oil prices stating that are many tailwinds like reduced spare capacity, strong world demand, potential outages, and tight supply conditions. Put simply, a production increase is welcome and needed, not too push price down but to prevent it from rising too much. Goldman reiterated its call for Brent price to average $82.50 in the third quarter. That's a lot of juice for oil producers that can fetch international prices.

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Technical Perspectives of the Sevens Report (May 31, 2018)

1. In spite of recently rising volatility, the broad uptrend in the S&P 500 remains intact 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 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 manner for months with key resistance at $1350 and a key support level at $1250. Neutral since December 4, 2017

4. Despite recent decline in bond yields, the 10-year bond yields are decidedly in a positive trend with key resistance at 3.11 % and key support 2.83%. 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