Issue 27

PALOS

July 5, 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

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau & Evan Weiser

Knock on Wood

Hardwoods Distribution (TSX:HDI) is the largest distributor of architectural building products in North America with 63 locations and over 1100 employees. HDI has become a vital link between large suppliers of lumber products and smaller industrial manufacturers. Currently, the three main revenue sources for the company are residential (50%), commercial (30%), and diversified (20%). Despite the competitive market position of HDI, it still only represents 10% market share in North America. The company has lots of room to grow both organically and through accretive acquisitions like the recent purchase of Atlanta Hardwood Corporation in June.

HDI's shares have fallen over 14% YTD off no fundamental changes in the company. Despite the pressure on the company's stock, Palos believes that the dip represents an opportunity as investors might have sold the stock due to trade war fears. HDI, which makes close to 90% of its revenue in the United States, sources 80% of its products from within the country. While some of the products sourced internationally might be viewed as at risk of tariffs, most of the international sourcing is spread among various south Asian countries significantly reducing any impact that tariffs could have on HDI.

Several positive momentum factors remain in HDI's favour. As per the U.S. Census Bureau, housing starts have remained strong rising 20% YoY in May. Despite the positive print, housing starts still remain below the annualized rate of 1.5M+ that is needed to keep pace with population growth and demographic trends. This suggests that housing numbers still have room to run. As HDI's products are typically sold to developers 9 months after construction has begun, we view these numbers as a good indicator as to future sales. Commercial construction has also been strong. Furthermore, gross margin pressure on Hardwoods due to the 2017 U.S. trade case against Chinese Harwood Plywood should subside in H2 2018 suggesting that higher earnings likely lie ahead.

The company appears to be undervalued. It currently trades at 7.5x 2019 EV/EBITDA as compared to its peers trading at 8.8x. The industry typically trades closer to 10x.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.70	0.84%
Palos Equity Income Fund - RRSP	PAL 101	$6.43	0.39%
Palos Merchant Fund L.P. (Mar 31, 2018)	PAL 500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL200	$9.13	-16.45%
S&P TSX Composite			1.88%
S&P 500			3.36%
S&P TSX Venture			-12.69%

Chart 2: Market Data*

	Value
US Government 10-Year	2.83%
Canadian Government 10-Year	2.15%
Crude Oil Spot	US $73.15
Gold Spot	US $1,258.50
US Gov't10-Year/Moody BAA Corp. Spread	199 bps
USD/CAD Exchange Rate Spot	US $0.7615

* Period ending Jul 5, 2018

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■ What is New on the Macro Level?

By Hubert Marleau

Monetary Policy Outlook: The U.S.

The core personal-consumption expenditures price index (Core PCE), a preferred price measure closely watched by the Fed, has reached the central bank's two percent target after running below it every month for six years. If one was to include food and energy, headline PCE is now running, year-over-year, above the Fed's target at 2.3%. The seven-year average is 1.3%. Structural factors have played a big role such as an aging population spending less, cheap imports due to globalization, the "internet effect" of selling goods online and a slow rise in the money supply. Nevertheless, it was bound to happen as tightening labour conditions have nudged wages higher and the long-lasting expansion has finally squeezed a lot of slack out of the economy. Also, the economy has just got a powerful dose of fiscal stimulus. Now, we have trade tariffs that companies will try to pass on to consumers complicating the inflation picture. While achieving the 2% goal is encouraging and perhaps good for the economy, it will become important to see if the Fed can maintain it. Fed officials believe that they have inflation firmly under control. They estimate that core inflation will hold steady at 2% in 2018 and minutely increase to 2.1% in 2019. Now the question is what the Fed is going to do about it. There are three main theses.

First, some say the Fed is willing to tolerate annual core PCE inflation as high as 2.5% before considering raising rates faster and higher than planned.

Second, others say that the Fed will be more relaxed if the annual core PCE inflation does not cross the 2.0% and keep the policy rate in check.

Third, many say that the Fed may be forced to lean against the economy more than planned because the economy is running too hot. Fuel-price increases and higher trade duties could easily feed into prices for a variety of goods and services.

We should start by establishing what the facts are. Hard numerical evidence shows that the U.S. monetary stance should be tight, not even keeled. The Palos Monetary Policy Index presently stands at 252. That is considerably above the 100-point threshold and significantly higher than the 148 reading registered at the end of December. Furthermore, the inflationary content of the misery index is currently 42% compared to 34% in December, and cyclically sensitive expenditures accounts for 27.6% of R-GDP compared to a normal rate of 25%. On the other hand, the monetary and financial indicators point to accommodation. The federal funds rate (1.875%) is 87.5 bps lower than Palos estimated neutral rate of 2.75%, 92.5 bps lower than the annual rate of inflation and 97.5 bps less than the 2.90% yield on ten-year treasury. Additionally, the 350 bps spread between high-yield bonds (6.35%) and ten-year U.S. notes (2.90%) is 125 bps above the annual rate of increase in the core CPI (2.20%). Thus, it would be prudent for the Fed to continue to move towards what the market calls normalization since there is still some room before policy reaches even keel – neutrality in the words of the market and equilibrium in the words of economists. The question is at what point will the monetary course tilt toward hawkishness or dovishness. At the time of this writing, the Fed plans to stay the course and increase the policy rate two more times in 2018 (September and December) and three times in 2019 (March, June and September) If the monetary and financial variables do not change, we would wind up with very different conditions than we currently have. Firstly, the federal funds rate would be 3.25% that would be 50 bps above the neutral rate, 45 bps above inflation and 40 bps above the yield on ten-year treasuries. Secondly, the monetary base is down and so is money supply. The personal savings rate must be rising since saving deposits have significantly accelerated in the past three months. It implies that the U.S economy could easily be in a recession sometime in 2020. Many market strategists see powerful forces converging that could trip up the expansion. However, predictions of this sort proved to be wrong more often than not. The question is whether the Fed will allow this scenario to unfold? My answer is no. It will take a bet that would err towards dovishness. The Fed will not intentionally cause a recession even it means allowing inflation to run amok for a while. I think that the Fed will be subtler than perceived and shrink the balance sheet by more than expected and increase rates by less than anticipated. These tactics would disallow that the yield curve from inverting.

Ignoring the practice of former administrations, Lawrence Kudlow, a top economic adviser, made a comments on monetary policy urging that the Federal Reserve should raise interest rates "very slowly." He argues that "faster economic growth does not cause inflation." That is true for as long as the economy is operating below potential or when productivity surges ahead. There are several

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new people at the Fed in key positions that were appointed by Trump; we do not know if they will succumb to the whims of politicians or not. Kudlow has not held back on his opinions that the monetary officials should let the economy rip. His argument is based on the notion that the $1.8 trillion fiscal stimulus will bring about enough supply-side benefits to overcome usual inflationary effect of having the economy operating at or above full potential under lots of fiscal stimulus. No matter how one cuts it, serious productivity gains will be needed since the pool of available labour is shrinking fast. This is not an easy one to figure out since productivity can be all over the place. It's an ingredient of economic growth that fluctuates the most and, therefore, is hard to pin down. Nevertheless, Kudlow may be onto something. Fiddling with tax and tweaking regulations may boost the cyclical component of productivity. Palos is presently estimating that productivity may have risen as much as 1.7% in the year ended June 2018. Approximately, ⅗ of productivity drops stem from sectors representing only ⅕ of output like finance, utilities, pharmaceuticals, computing and professional services. These sectors with productivity-deficiencies are getting resolved. Productivity gains would solve many economic problems. It would decrease input costs and usually increase profit margins. Furthermore, it would increase worker's efficiency and tend to lead to wage gains. It would decrease cost push and tend to lessen inflationary pressure. It would raise government revenues and reduce budget deficits. Edward Yardeni, an economic man with a remarkable record of predicting markets, believes that only economists of the pessimistic variety ignore the pleasant surprises that technology can bring.

I'm not convinced that the Fed is feeling the pangs of inflation anxiety. Interestingly, the headline PCE index may be up 2.3% over the year, but, in the past six months the annual rate of increase was considerably less at 1.8% and significantly less at 1.6% in the last three months. It shows that the Fed is not behind the curve. In fact, the cyclically sensitive inflation rate which responds to labour conditions that is of particular interest to the Fed shows no signs of significant acceleration. Theory tells us that under normal circumstances inflation is simply the product of increases in the money supply less real output. In the 12 months ended June 2018, MZM (money with zero maturity and immediately available to spend) is up 4.0% versus a yearly increase of 3.0% for R-GDP leaving only 1.0% for the broadly defined inflation. Yet, the annual increase in the GDP price deflator was 2.0% - the 1.0% gap between what should have been and what has occurred is explained by an increase in velocity. The velocity of money is often tied to productivity. Productivity growth has stealthily been creeping up since mid-2016. Productivity was essentially flat in 2016 but increased 1.0% in 2017 and current indicators suggest that it could print increase of 1.75% in 2018. Given that deeply entrenched deflationary forces like technology, automation, globalization and labour arbitrage and the loss of negotiation power of labour are still about, the additional increases in productivity should contain inflation.

Conditions in both the banking and market systems have tightened much more than it appears on surface. Credit spreads have widened, market volatility has risen, market fear are up and concerns over a possible tail occurrence is more present than it has been in months. These tighter credit conditions are taking place while the Fed is shedding billions of dollars worth of assets, the government is issuing record amounts of debt, the Fed is sucking in excess reserves and foreign central banks are disposing of their hoard of treasuries. Nevertheless, the exchange value of the dollar is exhibiting strength and long-term bond yields are below the equilibrium rate of 3.25%. Furthermore, China's yuan has slumped to its weakest value against the dollar in a year. It's hard not to believe that China not letting market forces take the Yuan down is a good strategy. The Bank of China talked up the Yuan yesterday, I think that it was for show. At a certain level, China will have a good excuse to sell a lot of U.S. Treasuries as a defensible decision. This will happen when it will feel that enough devaluation has taken place to cushion the blow of trade tariffs. And guess what? The highly optimistic outlook of most high frequency "now forecasting model" are being downwardly corrected and Goldman Sachs' US Financial Conditions Index (GSI) shows that in just six months we went from easy flowing money to tight financial conditions a year from now. The GSI is a gauge, closely watched by economists, that factors in a variety of macro variables such as interest rates, credit spreads, market volatility and currency levels to generate a reading on financial conditions. Meanwhile, oil prices are rising, copper prices are falling, and the yield curve is flattening. This is not a good combination for global growth. Fortunately, there are some good support levels for copper and good resistance levels for oil (see below). Nevertheless, these two price points need to be closely watched. Watch out for $2.75 copper and $90 oil.

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The greenback has done very well since the start of the year, the ICE U.S. Dollar Index (DXY) ran from a low 89.02 to a high of 95.29 for a 7.1% increase resulting from of widening interest rate differential between the U.S. and other advanced economies. It is unclear how long the Fed wants this bullish currency momentum to continue. There will be a point when the dollars strength will serve to slow growth and inflation. Forecasting currency performance is dependent on three independent factors: superior valuation as measured by the Purchasing Power Parity Rate (PPPR), cost of carry as ascertained by interest rate differentials, and business cycle comparisons as weighed by difference in economic growth among the big economies. While it is obvious at present that the two latter factors are looking good for the dollar, currency valuation must be of some concern to the Fed. Our research indicates that the PPPR expressed in Dollar Index Spot (DXY) should be about 85.00. The DXY was 94.50 on Thursday morning, an overvaluation of almost 12%. It should be noted that most cross-border money, capital, goods and service flows are not currency-hedged. It means that it would not need much relaxation on the part of the Fed to get the growth benefit of a lower valued greenback and at the same time heal the pain of exporters and stop the complaints of foreign dollar borrowers.

Our thesis supports a relatively quick return to what we call a “two-plus-two economy” two percent growth and two percent inflation. The Citigroup Economic Surprise Index, which traders watch for signs of shifting growth momentum, just turned negative for the first time since September after a string of weaker than expected economic data points. It makes sense as the Congressional Budget Office (CBO) has the potential GDP growth at 2.0%. In our judgement, the Trump Administration knows that the economy is about to experience a mid-cycle slowdown, making the Fed the culprit as opposed to the face-off with trade. Kudlow recently broke a precedent of refraining from commenting on monetary policy. In this connection, yield on ten-year treasuries are not likely to rise much above 3.00%. In recent appearances, Powell manifested awareness that monetary-policy levers are blunt and a willingness to trust evidence as much as models. At a conference in Sintra, Portugal a week ago, Powell mentioned that the Fed will be guided by what’s going on and what the real economy is saying. His understanding of full employment will be informed by reality and by what’s actually happening. This means that the Fed is not going to raise rates just for the sake of normalizing them. Stylistically, Powell will look more at current analysis. Such a strategy requires nimbleness and sometimes sharp changes in policy. A data-dependent approach is not the same as spoon-fed guidance. Against that backdrop, there will be many press conference and more noise. Thus, if our prediction of a “two-plus-two economy” is right, there will not be more than two or three policy rate increases over the next 18 months. More likely two.

Monetary Policy Outlook: Canada

The Canadian monetary authorities will raise thei benchmark rate another notch to 1.75 % next week because the April GDP numbers were better than expected. The Bank of Canada’s Business Outlook Survey (BOS) showed that business optimism was near record levels in Q2 and headline inflation is a bit above the 2.0% target. We think that it would be a mistake to raise rates in Canada since the Palos Monetary Policy Index stands at only 107 compared to 252 in the U.S. and the inflationary content of the Misery Index is 28% compared to 42% in the U.S.. Bottom line is that current economic data points suggest that the short-term interest rates should be where they presently are, about 75 bps lower than those in the U.S.. The failure to get a relatively easy NAFTA deal shows that if Washington does not get its way, there will be no deal until 2019 despite political pressure from big and small businesses. Canadians are gloomier as they are becoming increasingly uneasy about trade tensions and government inaction. What Canada should do is accelerate depreciation allowance to one year, reduce federal corporate taxes to 5%, do away with all import duties for similar treatment by other countries, get rid of interprovincial trade barriers, and build two new pipelines—one east and one west.

What’s Going on Right Now: The U.S

On July 5, the Atlanta Fed’s GDPNOW forecasting model estimated that R-GDP in the second quarter of 2018 will be up 3.8%, a further decrease from the high estimate of 4.8% a few weeks ago. Pantheon Macroeconomics is calling 3.2% for Q2. 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 GDP is still expected to show improvement in productivity - the economy’s long missing ingredient. It explains why the U.S. economy is running faster than it ought to. 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

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the annual rate of 2.2% up from 1.9% two weeks ago and the Atlanta Fed's Business Inflation Expectation is 2.0%.

The Goldman Sachs financial stress index, not yet at a critical level, but has steadily risen for months, 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 July 5 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-out for $2.75 and oil prices have surged to $75.00, watch-out for $90 a barrel. We are too far away from an inverted curve combined with much lower copper prices and much higher oil prices to panic- but, we shall monitor these market variables closely for herein lies the secret what is ahead. We are sticking with our view that the U.S. will print two-plus two economic figures in the fourth quarter of 2018.

The U.S. stock market is in a neutral zone. The "Rule of 20" which is the addition of the latest year-over -year increase in the CPI (2.80%) to the 12-month forward P/E ratio (17.10) stands at the neutral rate of 19.80. History is clear that the more the Rule is above 20.00, the greater the likelihood of a bear market ensuing while the more the Rule is below 20.00, the greater the likelihood that a bull market is coming. If one were to combine this observation with the recession risk, one would get a pretty good idea where things are going. At the time of this writing, the probability that the U.S will be in a recession in the next six months is low at 16%. The critical point is 30%. In our judgement, S&P 500 EPS forecast for 2018 is $159 reflecting a jump of 19% from last year. Our Forecast for 2019 EPS is $170 and $178 for 2020. Analysts who make bottom-up forecasts are more bullish than our top-down forecasts and predict $161, $176 and $196 respectively. In this connection, if the market continues to be stuck in the mud for a while longer, it's conceivable that the "Rule of 20" could end-up being around 16.00 by the end of year, especially if the Fed's inflation forecast holds. Given our scenario of the stability that a "two-plus-two economy" would produce, one should relax and go with flow.

What's Going on Right Now: Canada

Palos calculates that the Canada's neutral rate is now 2.00%, 75 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 76.00 U.S. cents on Thursday morning, up from where it was last week but still much less than our revised purchasing power parity rate estimate of 80 U.S. cents. The Loonie did better on the strong expectation that the Bank of Canada will raise its policy rate one more notch to 1.50%. The market thinks that there is an 85% chance it will happen compared to 50% a few weeks ago.

We think that it may be a time to chip away at the loonie while it's trading at a 5.75% discount to its PPPR of 80 U.S. 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 should be prescribed: lower corporate taxes, faster depreciation rates, less financial and business regulations, reduced import duties and freer trade among the provinces. It should be noted that barring an unravelling of NAFTA, most 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 U.S. cents by the end of 2019. The forecast is based on the notion that even friends and supporters of Trump are mounting strong objections to do away with NAFTA. Should clarity surface on this matter over the coming months, the discount would likely disappear because Canadian terms of trade are improving with the rise in oil prices.

Even though a real trade war would be devastating to Canada's economy, a very recent survey conducted by Bloomberg shows stock market returns are expected to be better in Canada than in the U.S. There may be a lot of macro and geopolitical risks. But, market valuation metrics are compelling, the Loonie is alluring, and energy prices are rebounding. In turn, based on the average of 10 estimates compiled by Bloomberg, the TSX Index will end the year at 17,068 for a six month gain of 5.0% plus dividends. The highest forecast is 18,000 and the lowest is 16,300 - all better than the June closing of 16278. Most of the upside should be with value stocks, energy, financials and materials, the later three sectors account for ⅔ of the S&P/TSX Index. Technically, the TSX is undergoing a minor but

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healthy pullback suggesting that the trend is positive. As a matter of fact, value stocks are particularly attractive and have undergone their corrections and are probably good buys.

The Global Energy Complex

On Thursday morning, WTI oil was trading for $74.50 a barrel, $19.50 over our estimated marginal cost of production. Now we have an oil war. President Trump is insisting that OPEC should do more to reduce oil price like lifting oil production by 2.0 million barrels a day. Oil prices are not budging since there are threats of Iranian sanctions and supply outages in Venezuela and Libya. Iran's oil export stands at 2.5 million b/d. The point is that if the U.S. was successful in their quest to halt Iranian oil exports, traders fear that countries with spare capacity will no longer be able to bridge the gap even if they were to produce at maximum levels. About 1.0 million b/d is being added because of last weeks OPEC-Russia agreement and that covers the cuts made in 2016. Interestingly, the Saudis reported that they could produce 12 million barrels a day, almost 2.0 million more than they are now producing; but only in six months and with additional drilling and investments. This sounds as if they are not ready to stretch the Kingdom to its limit and bring spare capacity to zero. It also means is that the oil spike may be temporary. In six to 12 months the Saudis could flood the market. The one-year future oil prices are $10 less than spot prices. In fact, the forward strip looks toppy, perhaps tippy. It supports the recent prediction of the Energy Information Agency (EIA) that oil prices have probably hit their peak for this cycle. That is why Palos is only market weighed in the energy sector and not overweight. I don't believe that the recent increases in oil prices are structural, they political.

Technical Perspectives of the Sevens Report (July 1, 2018)

1. Based on the Dow Theory, the trend for that S&P 500 is bullish with key resistance at 2816 and key support at 2630.—2728.75
2. Based on a proprietary model, the trend for Crude Oil is bullish with key resistance at $80.70 and key support at 68.19. —$74.50
3. Based on another proprietary model, the trend for Gold is neutral with key resistance at $1310 and key support at $1227.— $1253
4. Based on a proprietary model, the trend for 10-year treasury yields is bullish with key resistance at 2.99% and key support at 2.73%. — 2.84%

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