Issue 28

PALOS

July 12, 2018

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Morneau Shepell Acquires Lifeworks

Morneau Shepell Inc (TSX:MSI) entered into a definitive agreement to acquire LifeWorks (Life), for a purchase price of $426 million. Life is a leading global Employee Assistance Program ("EAP") and wellness provider, and has offices in the U.S., the U.K., Australia and Canada, with more than 500 employees worldwide and 4,200 existing customers across 57 industries. MSI is financing the $426 million by raising $210 million in equity and upsizing its bank facility.

On a fundamental basis, the acquisition is accretive. The purchase price multiple is approximately 11x 2019 EBITDA. MSI is expecting the acquisition to be over 10% accretive to EPS. However, more importantly the acquisition brings five strategic business opportunities.

1. Life is leader in global EAP and wellness, and it has a recurring revenue business model.

2. Life has a strong technology platform

3. Life has a joint venture with a strategic partner "Ceridian HCM, Inc"

4. Life generates approximately $105 million of revenue.

5. Life has offices in the US, UK, Australia and Canada that MSI can leverage in the future.

In conclusion, Palos believes this acquisition is accretive and strategic to MSI. The Palos Income Fund and the Palos Equity Income Fund both participated in the raise.

■ Mendel's Option Corner

By Robert Mendel

Back from a one-week vacation.

Lots of people still think that once you sell a covered call you are locked into an agreement to deliver the shares with no way of unwinding that agreement. That's not true. There is nothing preventing you from buying back the short call and there are many reasons you may want to. Dividends are one of them.

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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Take for example my play on TD Bank. I bought it at $72.90 and simultaneously sold the April 74 calls and then subsequently rolled those over to July 74 (we discussed rolling before) bringing my net cost to $71.25. On July 6th, the stock was trading at $75.75 and was going x-div on July 9th paying 67 cents. Since my short call strike was 74, I knew the stock would have been taken away from me if I did nothing as it was deep enough in the money. But I wanted that dividend.

So, I rolled the option over from July 74 to Dec 76 and collected an additional .22 cents along with the $2 higher strike price. While this translates to only 3% for the extra 5 months (7% annualized), it did allow me to collect at least one more dividend and perhaps as many as two more for a total of 3. This increased my overall return without any added risk other than exposure. Not bad for a conservative play.

Let me finish up this week by saying thank you to those who opened accounts with me because of this letter. So far, we are off to a good start. And for those who haven't yet, it's ok, I know you will, so thank you in advance.

■ What is New on the Macro Level?

By Hubert Marleau

The Trade War: Beware the Ides of November

Investors have been subject three painful trends that make economic growth vulnerable. These are rising interest rates, declining copper prices and spiking oil prices. The fallout of this trio won't mark the turning point of this business cycle but should cause a pause. History is clear that when the trio acts in the way that it recently has, it brings economic fallouts. Fortunately, periods of this sort don't last too long for something usually breaks. A good place to starts is with the performance of the components and their close cousin the U.S.dollar. Let's have a look at the data-trend.

The price of WTI oil is up from $60 a barrel since the end of December reaching a high of $75 a few days ago, representing a 25% increase.

Copper prices were $3.35 last December. They are now $2.75 for a 18% decrease.

Yields on two-year Treasury note ran up 65 bps from 1.90% last December to reach a high of 2.85% two weeks ago.

The DXY index shot straight up from a low of 88.65 in early February to 95.25 for an increase of nearly 12%.

Accordingly, we are about to witness a mid-cycle economic slowdown ---not a recession because it seems as if oil prices have peak, copper prices should stabilize and the yield curve remains positive and the rise of U.S. dollar is deflating. It means a pause to slower growth and a return to what we call a "two-plus-two" economy.

Nevertheless, what is terrifying is that the fiery rhetoric around trade could be interpreted as being the reason for the forthcoming pause rather than the natural process of a long-standing business cycle bringing collateral damage to the rest of world and the wrath of world consumers on American goods--- especially, if an eruption of full-fledge trade war is blame on the U.S.. Conservatives in the tradition of Adam Smith would argue that trade barriers and protection offered to dying industries will not serve the interests of the people. On the contrary, they ossify economies that eventually splinter in the face of competition.

The U.S. administration has started a four-front trade war (China, Canada, EU, Mexico) introducing multi tariff walls on combatants including friendly allies and competitive rivals--- all in the the service of making the world order of trade just and fair. Unfortunately it's not that easy. Game theory teaches that "Tit-for-Tat" is costly for both party in different amounts, nevertheless costly overall as opposed to the win-win conclusion of co-operation which benefits both party, perhaps also in different in amounts, but beneficial overall. Understandingly, the rest of the world has already stated malcontentment with Trump's tariffs and has retaliated with its own set on tariffs on U.S. goods—when aroused, will resists. It's a dangerous game for spreading yourself over too many fronts invites defeat. Joshua Meltzer, a senior fellow and specialist in international trade at the non-partisan Brooking Institute, does not understand why Trump decided to wage war on everyone at once. It shows a lack of a complete strategy--maybe. Mr. Meltzer added "This administration didn't have the faintest notion of how various countries would react and wasn't prepared for it--maybe. Trump thinks that the U.S. is big enough to bully people. That has proved manifestly wrong. I find it odd that Trump does not jump on the advances that Taiwan and Switzerland made. They would consider some bilateral free trade agreements. It shows that it would be much easier to go after the culprit by

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enlisting friendly nations like the U.K., E.U., Canada and Mexico and Japan to your side and deal with China first. It's where it should of started. After all, China disregards for intellectual property rights, unequitable protection for favoured industries. China tends to tilt the playing field and seeks unreasonable relief from the WTO. China makes the notion of "free trade", an illusion as businesses and government collude to exchange favours creating unfair advantages.

Before the misfired tariffs and counter-tariffs, the U.S. had an actual plan for dealing with China's misbehaviour. It involved marshalling some of the other countries harmed by China's trade barriers and intellectual property theft. A lot of countries are victims of China's abusive practices--Canada, E.U, U.K., Japan, Australia. The idea was to contained China's influence by preventing the Chinese from writing the "rules of the road" on intellectual property, labour, and environmental standards. They all signed in 2016 without the U.S..

It's true that China has never accepted the liberal order or its values. It is difficult for China to assimilate in the prevailing classical liberal ideas that there is linkages between trade, economic growth and democracy and that faith in the presumed universality and irresistible power of human desire for freedom. The Chinese Communist Party has a monopoly on domestic political power. Yet,there are many big changes taking place in China. One big change is the declining importance of trade on growth---today, China is more investment-led than export-led. The other one is the vulnerability of the Chinese economy--it's overloaded with debt. Total debt is now estimated at over 250% of N-GDP resulting sharp increases in defaults, according to Fitch Ratings. The Fulcrum nowcasting models and the Goldman Sachs activity trackers are predicting a slower underlying growth than the current 7%. All in, the trade affair will probable knock-off 1% to 2% of its growth potential.

Unfortunately, the U.S. drew "first blood" and has caused all allies to band together for strength of unity. Instead, there is a sense of mistrust in each other and a good chance of a failure for an equitable world trade system. To make matters worse, he threatened to withdraw from the World Trade Organization (WTO), willing to violate the spirit and the letter of commitments the U.S. made as a member and to destroy the stability needed for multinationals to build efficient supply chains and reduces the economic cooperation and integration. It would much better if Trump would work on modernizing the WTO and find remedies and relief before damages from unfair trade practices become permanent. Consequently, the mess is driving U.S. trade partners to develop new agreements like the Trans-Pacific Partnership, the Regional Comprehensive Economic Partnership in Asia and China-E.U modernization plan for global trade rules excluding the U.S.. In my judgement, too much is in the open---negotiations should be done with a lot of preparatory work and in closed quarters and made public for scrutiny when ready. Remarkably, the Trump tariffs on a Chinese goods target U.S. and other non-Chinese companies and mostly miss Chinese ones according to Peterson Institute for International economics.

David Flicking wrote a few days ago in Bloomberg that " as with any war, it's important to understand why this one is happening'. As with many wars, the "raison de guerre" is exaggerated by who starts it. --- in this case, trade deficits and national security were given as the formal pretexts. It's a ridiculous argument for allies are not military threats, the service account of the balance of payment is neglected and so is long term capital capital inflows. On this last one, foreign direct investment in the U.S. accounts for about 2.25% of N-GDP while the current deficit account balance is 2.5% of N-GDP. Presently, number-crunching models that economists use to built forecasts on what should the ultimate effect of the tariffs put in place is so far minimal. The Moody's Analytics model shows that the tariffs will shave all of 0.03% of R-GDP in Q3 and 0.1% in 2019. It looks small, but there is a psychological side to all of this that makes me less sure about the reliability of conventional model when it comes to trade tariffs. Models do not handle left field uncertainties well and confidence can hit business and consumers in weird ways and will is resistant when aroused. American industries have manifested some malcontentment about Trump's trade blitz. The trade question is important because it hurts . It is known that U.S. businesses have superior managerial methods. They have a knack of automating work rather than workers. This was point-out to me by one of my readers. American superior management use domestic skills leveraging it in low cost in countries as a resource. Off course, this may not work so well when immigration is cut-off, trade and investment protection is applied and the inventory of skill workers is limited, especially in a full-employment scenario.

But, complaints of business have been tempered by their appreciation for the tax cuts and

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deregulation. It remains that the business community knows that international trade is complex affair and, in turn, tariffs could produce all sorts of secondary effects on inflation, investment decisions, supply chains, international commerce, and even monetary policy. There is talk that trade wars would create not only multiple supply chain disruptions; but, also movement of American investment capital to Canada, E.U, Mexico and TPP members to avoid foreign tariffs. Whether trade is fair or not, unfortunate or otherwise, when companies start saying that tough decisions that entail the reduction of investments in the U.S. as result of trade disputes, one needs to accept that decades of globalization can be quickly rewritten and expect the U.S. to come out as a clear winner---negative spillovers are inevitable. JPMorgan in a recent note to investors said that tariffs could very onerous when the content of end products that cross borders many times and when only a certain percentage is domestically sourced. Some of the stock market's biggest decline have occurred when trade tensions escalated. If one was to assumed car tariffs plus a 25% tariff on $400 of additional Chinese goods, the U.S economy would take, at a minimum 1.3% growth hit of and a 0.5% inflation boost to our predicted "two-plus-two" economy. Trump is "playing chicken" with the economy. How long will this last will dependent on how much all economies (U.S. and the rest of the world) are willing to suffer the pains. One of my buddy send me an analysis that showed up in the CBC a few days ago. It basically states that the American blueprint is to force the supply chain to come back inside the U.S. borders to reinforce " Fortress America" by following through on his threats to hit China with $500 billion in tariffs erecting a trade wall across the Pacific, and do the same with the Atlantic Alliance with auto tariffs and with Canada and Mexico by abandoning Nafta. A isolationist economic policy is doable on the grounds that the U.S. is nearly a closed-end economy---exports account for only 12% of N-GDP. That is why that it may be emblematic of a concerted effort to rewrite the rules of global commerce for Trump may think that the effort is not a suicide mission. Axios has obtained a leaked draft of a Trump administration bill--ordered by the President himself--that would declare America's abandonment of fundamental WTO rules. The bill would give Trump a dictatorial license and unilateral power to raise tariffs at will. I can't imagine that how Congress could ever give such authority to a president abolishing congressional power and damning international order. In some circles, many think that President Trump is a free-trader. At the G-7 meeting, he repeated that he would support zero tariff if they were no barriers and no subsidies. It's hard to be against this kind of thinking. Edwin J. Feulner, founder of the conservative Heritage Foundation, said that he would be all for it. Just about every reputable economist teaches the virtue of free trade—-it is one of the few propositions that unites economist across the political spectrum. There is both empirical evidence and theoretical validity that free trade redeploys capital, labour and commerce to their most effective uses. Kudlow, chief economic advisor and longtime free-trade advocate said that the tariff threats are means to an end—-a wake-up call to American trading partners who have gamed the system to their advantage. Despite all of this, it sure does not look that zero tariffs is part of his agenda. The opponents of free trade are odd allies like populist, nationalist right and anti-free-market left; but, many of these are part of his base. Daniel J. Ikenson, director of the center for trade policy studies at the libertarian Cato Institute says: "Trump see this whole thing as a zero-sum game with the trade deficit as the scoreboard. That is an absurd approach". His methods of consistently tweeting demonstrate that winning is what matters whatever the means. It's been effective at the domestic political level like blocking democrats from getting ahead, driving everybody crazy and keeping the Republicans at bay. He's the Picasso of tweets. Therefore, this is not a normal trade dispute. It's hard to figure what is the President's goals because of his unpredictable reaction to events as they roll-out and, in turn, difficult to square them with what most people think what are conventionally normal commercial relationships. Also, unpredictable because he has surrounded himself with officials that have different points of views (Kudlow versus Novarro). One day it's about reducing all tariffs to zero and another day it's about raising them everywhere. What is becoming clear, is that he wants to repatriate the global supply chains in manufacturing, cars and steel, at least a big part of it, to America.

I'm not so sure that foreign nationals, foreign countries, multinational businesses, think tanks, international organizations, exporters and importers graciously support that goal. And, they also part of the U.S. citizenship. The results, from a new poll conducted by the Washington Post and George Mason University lash a warning signs to the White House---went it comes to trade offensives as tariffs slowly ripple through industries, Trump is 16 points underwater with voters on his trade agenda. He's surely aware and he may be force to back-off a bit. I say a bit, because not all the electorate accepts theories that

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free trade lifts all boats. It's wrong to think this way for deficits are normal and trade is about comparative advantages. Allan S. Blinder of the WSJ wrote a brief introduction to trade economics a few days ago---a must read. If you want it let me know: hmarleau@palos.ca

I've noticed that the U.S. tariff choices were so far driven more by politics than economics.This is not idle speculation, I check-it out thoroughly. This morning, the U.S. administration announced that "high-level" trade negotiations with China will resume hoping to achieve a resolution to end the trade war.

When it comes to Canada, it's faith may depend on the outcome of the November's mid-term election. Congress has the constitutional right to regulate trade. A few swing seats favouring a Nafta deal could bring about a veto majority that might overturn the tariffs or revoke executive power to impose them. The Senate pass resolution--perhaps an innocuous one--that stipulates that Congress ought to have a role when tariffs are imposed for national for national security reasons.

In this regard, I trust that Nafta will survive for there are misleading claims about U.S. trade with Canada. Firstly, the U.S. has a trade surplus with Canada. Secondly, the U.S. has a substantial dairy-trade surplus with Canada. Moreover, the dairy trade with Canada is only $500 million---small potatoes. Thirdly, Canada's effective tariff-rate is the lowest of the major developed countries. Lastly, imposing tariffs on Canadian commodities can bring job losses and higher prices as manifested by the imposition of a 21% tariff on Canadian lumber. In this connection, common sense and logic dictate that the Nafta envelop should not be push too far for enormous amount of research clearly shows that Canada is not the cause of unfair trade practices with the U.S.--on the contrary. Its probably why the TSX has relatively held well compared to the Shanghai Composite. The TSX/S&P 500 ratio is holding up even when one adjust values with currency prices. It has not been the same for the Shanghai/ S&P equity ratio. And, when the ratio is Yuan adjusted, its a lot worst. This huge difference in equity and currency performance between Canada and China expresses shows that the market belief that the real troublemaker in world trade is China. There is hope, naively perhaps, that it would be better to sanction integration between the three partners. This hope is based on the fact that when "value-added method of trade accounting is used, the U.S. has trade surpluses with both Mexico and Canada.

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

The U.S. stock market shrugs off the rhetoric over trade hostilities, the talk of recession and concerns over a monetary mishaps. The S&P 500 is up 8.0% since this year low of 2581 printed on February 8. The performance suggests the market is focused on solid economic fundamentals, widespread optimism among small business owners, and better than expected earnings.

On July 12, the Atlanta Fed's GDPNOW forecasting model estimated that R-GDP in the second quarter of 2018 will run at the robust annual rate of 3.8% and the Cleveland Fed's Inflation-Now-Casting model is estimating that Core PCE Inflation will show an annual running rate of only 2.1% for the period under consideration..

According to Moody's Analytics, the chances that the economy will be in a recession in the next six months is 15%, one percentage point than the last reading and far away from the critical threshold of 35%. While credit modes have tightened of late, indicators of financial stress and of monetary conditions as reported by the St-Louis Fed and others are in good stead. Palos calculated on July 12 the U.S. neutral rate was 2.75 %, 75 bps more than the yield on three month treasury bills - three hikes for a flat yield curve.

These are three rate hikes that the Fed is planning on are credible. The market does not believe in them because traders are sceptical that the Fed will go ahead with them. They think that foreign bond yields are so low that they have broken the correlation between the 10-year bond yield and the growth rate of N-GDP. As a matter of fact, expected federal-funds rate several quarters ahead derived from futures market prices suggests that traders are putting low odds that the yield curve will actually invert.

It is highly likely that the first quarter of 2018 was the peak in EPS growth or this profit cycle. The quarter produced a record 27% year-over-year increase. Q2 will end up as the second best gain in over seven years registering an increase of about 20% from a year earlier. Profit growth will continue to decelerate from these extraordinary and lofty levels as wage gains, trade tariffs, fewer unemployed workers and reduced spare resources become more problematic. Nevertheless, good steady profit increases are forecasts for the next

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12 months. Understandably, industry analysts in aggregate are predicting that the S&P 500 will see a 13% increase in price over the next 12 months.

The U.S. stock market is still 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 (17.18) stands at the neutral rate of 19.98. History is clear that the more the Rule is above 20.00, the greater the likelihood that a bear market is about while the more the Rule is below 20.00, the greater the likelihood that a bull market is coming. Another way of looking at it is that the stock market usually stalls when ten-year government bond (2,85%) are close to the S&P 500 earning yields (5,85%)---300 bps is a neutral trading zone. That could change for the better for earnings are still growing fast. Take away the trade and it turns out in some kind of an agreement is reached the bull run will resume. Look at advances versus the declines. Many more advances; that is very telling that we are getting a bullish setup says Leon Tuey.

The odds are that jobs growth will moderate sufficiently over the coming months to decelerate the pace of economic growth. Job openings were down in May, initial claims for unemployment insurance are rising and the pool of available workers is shrinking. In this connection, Q3 is going to be much different than Q2 for the pace of economic activity will slow down to more sustainable level. Productivity gains, not employment increases are what will keep the economy going forward.

What's Going on Right Now: Canada

The Bank of Canada (BOC) brushed aside concerns about trade wars, poor economic growth and mild inflationary pressure and raised its overnight benchmark rate by 25 bps to 1.50%; and Governor Poloz did not introduce dovish language suggesting that the Governing Council anticipate to raise rates another three times to 2.25% by the end of 2019. It may turn out to be a policy mistake for there is little hope that the economy will generate an annual rate of growth of 2.8% in Q2 and will probably slump below 2.0% in Q3 at a time when core inflation is only running at the annual rate of 1.3% and a lot of subprime borrowers. Of the 28.4 million credit active 11.9% fall into the subprime category, according to TransUnion. It appears that the BOC is betting that export will pick-up even though Nafta may be in jeopardy. The Palos Monetary Policy Index and the inflationary content of the Misery Index suggested that the BOC should of adopted a wait-and-see approach.

It looks as if Governor Poloz wants to keep the Canadian yield curve around 50 bps lower than the one in the U.S. It's a risk for the pace of the U.S. N-GDP is running at the annual rate of at least 5.25% compared to 3.75% for Canada. Moreover, the Canadian neutral rate is 2.00% versus 2.75% in the U.S. Theory and experience dictate that when the monetary stance ought to ease but actually hardened, the value of the currency should rise---particularly when it trades below its Purchasing Power Power Rate (PPPR). In the last few days the Loonie did go up a penny to 76 us cents versus it PPPR of 80 us cents. Should speculators decide reload their themselves with short position----a possibility for not much has economically change---a contrarian may want a chip away at it and advantage the disparity between the spot price and the PPPR.

The Global Energy Complex

WTI oil price rallied sharply in recent weeks to $75 a barrel as supply issues around the world arising from strikes in Norway, sanction against Iran, shut-down in Canada's oil sands and outages in venezuela---a perfect storm. All of temporary nature, but too big of factors to overcome in the short term---yet, $20 over the marginal cost of production means that the oil market was ripe for a correction and a technical selloff. It came when Libya's state run National Oil Corp. lifted force majeure on eastern ports paving the pay for a resumption of full production that could add thousands of barrels of oil to the market easing fears of a supply shortage. On Thursday morning, the spot price for oil was $69.50 a barrel, $5.50 less than it was last week and $14.50 above the our estimated marginal cost of $55 per barrel. It is conceivable that the marginal cost of oil may less than our estimate. Now, we have "digital oil fields" embracing artificial intelligence, automation and underground tools that are upending the business. These new methods are doing the work better and cheaper with fewer people. Nationwide oil production is up 25% since 2014 and employment is down 20%. This translate into a 50% increase in productivity----if get the cost of capital is included, we would end up with a 10% reduction in the marginal cost of production. I need to check this out. But a quick calculation takes reduces the average cost to $50 a barrels. It means that despite the recent price decline, there still $20 of froth. That does not mean that that oil prices are heading there now,

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for there is enough speculation surrounding oil to hold the price premium. But…...

Technical Perspectives of the Sevens Report (July 7, 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. — 2790.

2. Based on a proprietary model, the trend for Crude Oil is bullish with key resistance at $78.43 and key support at $68.19. — -$69.50.

3. Based on another proprietary model, the trend for Gold is neutral with key resistance at $1310 and key support at $1212. — $1244.

4. Based on a proprietary model, the trend for 10-year treasury Yield is bullish with key resistance at 2.99% and key support at 2.73%. — 2.86%

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