Issue 29

PALOS

July 19, 2018

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Palos Weekly Commentary

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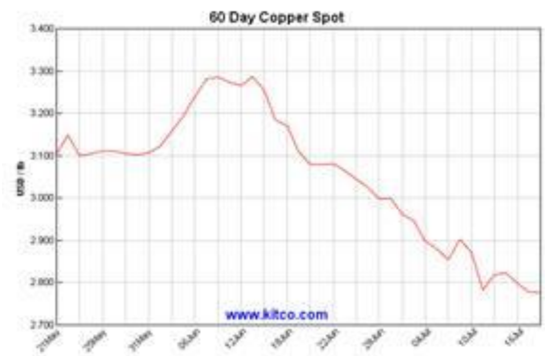
■ Palos Funds

By Charles Marleau

Copper is Down: Why This Could be Positive for Lundin

Lundin Mining Corp (TSX:LUN) is a diversified base metals mining company producing copper, zinc, nickel and gold. Approximately 59% of its revenue comes from copper. LUN is in a much different scenario than most copper companies though as it has over US$1.5 billion dollars of cash and equivalents on its balance sheet. LUN is extremely well positioned in this copper price environment. The commodity is down 16% from its high.



On July 16, 2018, LUN announced that it intends to make a formal offer to acquire all of the issued and outstanding shares of Nevsun Resources Ltd (TSX:NSU) for cash (US$1.1 billion dollars) or (CAD $4.75 per share). This is not a friendly offer as NSU management believes the company deserves more. Furthermore, NSU publicly stated that they recommend shareholders take no action in response to LUN's offer. NSU stock is up 82% since LUN expressed interest in NSU. NSU and some sell side analyst are preaching that $4.75 per share is still inadequate as the offer is 20% below NSU's NAV.

Palos does not believe that a higher bid is coming and NSU shareholders should be careful. LUN's management team is extremely disciplined and conservative and will not overpay. The downside on NSU is now significantly higher then the upside. If LUN walks away from this transaction NSU's share price can easily move down 40%, especially in this copper pricing environment. We believe that most shareholders will tender at this price as the downside risk is too high and base materials have fallen out of favour.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.81	0.88%
Palos Equity Income Fund - RRSP	PAL 101	$6.49	0.17%
Palos Merchant Fund L.P. (Mar 31, 2018)	PAL 500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL200	$8.96	-16.28%
S&P TSX Composite			3.67%
S&P 500			6.00%
S&P TSX Venture			-16.07%

Chart 2: Market Data*

	Value
US Government 10-Year	2.84%
Canadian Government 10-Year	2.11%
Crude Oil Spot	US $69.46
Gold Spot	US $1,224.00
US Gov't10-Year/Moody BAA Corp. Spread	190 bps
USD/CAD Exchange Rate Spot	US $0.7536

* Period ending Jul 19, 2018

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If NSU gets acquired at CAD$4.75, it will be very accretive to LUN and the assets are a perfect fit to their portfolio. Palos sees bigger upside in LUN with minimal risk. On the other hand, we see NSU as high risk with low potential returns coming from a higher bid. Because of the price action on copper, LUN will probably benefit from this as it has created uncertainty on a potential higher bid. NSU shareholders should be getting worried that copper prices will make LUN complacent. Cash or buying assets at a discount are both good for LUN in this environment.

■ Mendel's Option Corner

By Robert Mendel

Goldman Sachs was recently quoted in an article saying that playing volatility through earnings with options was a profitable strategy. I think they stole my diary but who is really going to complain, they all end up in the White House. Anyway, a few months ago I wrote about playing weekly options based on earnings and mentioned Amazon. Now it's Netflix's turn.

On Monday July 16, Netflix was set to report after the close. What did I do? That afternoon, with the stock at $397, I sold the July 20 395 puts for $16.50. This was my max profit and with a break-even of $378.50 ($395-$16.50), I thought it was a good bet since numbers don't lie as it translated into a 4.1% return in 4 days (if I was right).

Oops…it missed on subscriber growth by a large number and presto, the stock was down 13% after the report to trade in the $345 area. Luckily, this is where the premiums work for you. I licked my wounds and when the stock rebounded to $365 I rolled the puts to the August 395s for an additional $4.20 bringing my total credit to $20.70. Now my break-even is $374.30 ($395-$20.70). As I write this, the stock has since rebounded a little more and is in the $370 range. I could close out my option for a small loss, but as I said before, that's no fun, especially since I like the stock. And as long as I can collect premiums I will play this out. I will keep you updated on how it turns out.

Speaking of updates, remember the cheese play where I sold Saputo July 38 puts? Well it expires today and since the stock is over $44 I think we can put that one in the win column with a 4.2% return in 93 days!

■ What is New on the Macro Level?

By Hubert Marleau

The Stock Market is Stuck in the Mud

If one is in the business of making stock market predictions, it's important not to disregard the signals that have been good precursors of economic expansions, slowdowns, pauses and recessions. Thanks to the WSJ Market Data Center, we've able to observe that stocks have been in an usually long sideways struggle. The S&P 500 registered a record high of 2873 on January 16, 2018, only to enter into correction territory on Feb 8. A correction represents a 10% decline from a recent high and lasts until the index recovers or enters into a bear market which is 20% off the high. On March 23, 2018, the index printed 2588, that's is exactly 10% of the most recent high (2873). On July 19, the index was 2810 and therefore we have been stuck in the mud for 119 days. That is a long time since the average correction does not last any longer than 45 days and there has been only two other long correction periods, one that ended on May 10, 2008 and another that ended on August 7, 1984.

The stock market is "in waiting" wondering what it will be next: growth, a slowdown, or a recession. Presently, the probability that a recession will occur is 15%. This number only becomes problematic when it breaks through the 40% threshold.

A bit of history might be helpful to explain the importance of fear that investors have over recessions. The last time the market actually peaked was in October 2007 when the recession risk had reached 40% two months before. And, throughout the bear market of Oct/2007-Jul/2009 the recession risk hovered over 50% from Sept/07 to Jun/08. The economic contraction actually started in July/08 and ended in Jun/09. In January of 2008, six months before the economic contraction actually began, the recession risk peaked at 65%. Interestingly, from that peak of Jan/ 08, the presumed risk of a recession declined every month to 40% in July/08 when the recession officially started. During the 12-month recession of July/08 to June/09, the recession risk hovered around 40%. When the current bull market started and the recession ended in July/09, the recession risk was 35%. Put simply, the fear-risk that there could be a recession in the next six months needs to be at least 35% and rise higher from that point. Thus, one should not fear the coming of a recession until the recession risk reaches 35%. Palos is confident that over the next few months,

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economic growth and price-inflation will only rollover from the peaks that were registered in Q2 and pause to a 2.0% slowdown. This reasoning is based on the world-wide decrease in the supply of dollars and the flattening of the yield curve. In our judgement, current economic vigor is only reflecting short-term fiscal stimulus stemming from the Trump administration's tax cut. From here on, natural forces of employment and productivity will determine the economic outlook. Let's have a quick look at our premise.

The Global Monetary Base (GMB), an idea developed by the famous economist Rod McKnew, is the product of assets held by the Federal Reserve Bank (FRB) plus assets held at the NY Fed for the account of foreign central banks. Because the U.S. dollar is the dominant reserve currency, the GMB is a good proxy of global dollar liquidity, especially if it's adjusted for inflation. Gavekal Research intelligently argues that a low amount of GMB is synonymous with a shortage of dollars while a large amount reflects abundance. The GBM, which was expanding at a 20% growth rate from 2009 to 2014, has shifted its trajectory to basically no expansion since 2015. In fact, a reduction in dollar abundance is observable. The U.S. dollar is appreciating, metal prices are falling, emerging markets are vulnerable and international trade is contracting. We do not have a dollar shortage yet for the level of the GMB is still very elevated by historical standards. But history shows that reduced abundance undercuts economic growth.

Secondly, the yield curve has captured the attention of Wall Street for good reason. This so-called yield is perilously close to predicting a recession. Every recession for the past 60 years has been associated in one way or another by an inverted yield curve, according to research from the San Francisco Fed. Curve inversions have "correctly signaled all nine recessions since 1955 and had only one false signal, in the mid-1960s, when an inversion created a slowdown. This focus on the shape of curve has centered on five bond pairs.

The first pair that garners attention is the gap between 2-year and 10-year Treasury yields. At the end of 2009, the difference was 275 bps compared to 25 bps today.

The second pair (that the NY Fed likes the most) is the gap between 3-month bills and 10-year Treasury yields because the gap has conclusive power. At the end of 2009, the difference was 375 bps compared to 85 bps today.

The third pair is the gap between 5-year and 10-year Treasury yields, a reliable measure of inflation expectations and economic strength. The spread was 300 bps at the end of 2009 compared to 11 bps today.

The fourth pair is the gap between 7-year and 10-year Treasury yields, known to be the canary in the mine forecaster of un-predictive things to come. The spread was 50 bps at the end of 2019 compared to 5 bps today.

The fifth pair is the seldomly watched gap between 10-year and 30-year Treasury yields. A good fault line was 110 bps at the end of 2019 compared to 10 bps today.

As a rule, the forces driving yield inversions are irrelevant because their effect on the logic and psychology of the market is always the same. The slope of the yield curve acts as an incentive when it is steep or as a disincentive when it is inverted for bank credit creation and investor perception of its significance. Specifically, a flattening curve makes banking, which is basically the business of borrowing money at the short-term rates and lending it at long-term rates, less profitable. Banks are in the business of not losing money. It should be noted that the yield curve is not inverted anywhere on the strip and maybe, just maybe, this time could be different.

Changes in the bond market and in the economy may have made the yield curve a less useful predictor. The Fed and other central banks own huge amounts (trillions of dollars) of government securities and these holdings are probably holding down term risk to zero and, in turn, yields. Moreover, foreign bond yields of advanced economies are much lower making U.S. bonds very alluring. Bonds do not trade in a vacuum. For example, two-year U.S. bond yields are 325 bps higher than those in the Germany and 275 bps higher than in Japan. Furthermore, ten-year bond yields are 250 and 280 bps respectively higher. Together, these two factors are lowering U.S. bond yields more than they would otherwise be. This is certainly a big reason why ten-year treasury yields are only 2.85% when they should be as high as 3.50% if circumstances were normal. It may be the reasons why the Fed is not overreacting to the flattening of the yield curve for it may feel that its current shape has less relevance in today's regime and less predictive power. Consequently, the Fed decided to push on with normalization. Nevertheless, there is a divergence of opinion between Fed and market expectations presenting another conundrum for the policy

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makers. If long term rates refuse to rise (decline to incorporate higher short-term rates and rising inflation) to reflect the fiscal effects of the tax cuts on aggregate demand, budget deficits and insist on paying bigger risk premiums, the monetary authorities will be confronted with a choice of either inverting the various term spreads or standing down. The headline question is whether the Fed will invert the curve. Because short-term rates are artificially pegged, the Fed can easily back down. Readings on the thinking of voting members of the FOMC are pretty clear that they will not allow such an occurrence. If there is any significance to the copper-gold ratio, ten-year long-term interest rates could fall some more, or at least stay below what could be considered their equilibrium value. Jeffrey Gundlach, the new bond king, has weirdly claims that "if you average nominal U.S. GDP and the German 10-year bond yields, that's where the 10-year Treasury should be. The German 10-year yields 30 bps. Average that with N-GDP and you get about 2.65%. So, 2.65% is my year-end number."

Speculators see the potential for yields to reverse course for they have piled into near-record bets in 10-year treasuries through the futures market. What are do the speculators see? I say that it's less growth with not much inflation. Since the end of December, ten-year treasuries are up 46 bps of which only 12 bps resulted from the expectation of higher inflation.

Copper and emerging-market currencies have figured out how to price an outlook for lower growth and lower inflation. Consumer and business sentiment is falling as reported in recent surveys. The Federal Reserve noted that companies are signaling their intent to freeze capital expenditures and that consumers are likely to be the subject of an adverse supply shocks that should push up prices and reduce aggregate demand. So far, there is no hard evidence confirming that the economy is actually slowing. Nevertheless, indices of soft data are suggesting that there is as much uncertainty about growth as there is over inflation. We are sharing the same opinion as the bond market that the immediate effect of added duties will fall mainly on intermediate goods and, in turn, more on inflation than on growth. There is more on this story. It is widely known that the Fed would like to see accelerating inflation coming from real wage gains. This is not happening. The annual rate of consumer inflation (2.8%) is higher than year-over-year increase in average hourly earnings (2.7%) implying that real purchasing power is flat. The Fed might cool their jets and trust that the recent uptrend in productivity is the only thing that will carry-on. This once again brings us to our proposition that the economy will get off its high horse and go back to where it has been for a decade, 2% inflation and 2% growth. I demonstrated in past weekly commentaries that economic stability is what the stock market likes and that is what the bond market obliges. We believe that the economic expansion will continue but at a slower pace reducing profit growth and employment momentum. We do not face a level problem meaning no drop in the level of profits or employment that are normally associated with recessions. The Fed's Beige Book, with anecdotes from business across the U.S., has not only manifested concerns about tariffs, but also reported that the economic outlook was one of moderate growth.

As an aside, allow me to give you the conclusions of a recent Macquarie study that I stumbled upon last week. Conventional wisdom states that when a recession is approaching, one of the first signs that things are starting to go downhill will be a substantial and sustainable fall in the stock market. It is true that the stock market falls during a recession but generally not beforehand. The bottom line is that "as one would expect, we (Macquarie) find that equity prices have historically declined significantly around recessions as defined by the National Bureau of Economic Research (NBER). However, we find no clear pattern as to the behaviour of equity prices in the lead-up to recessions." Macquarie added that "we also find that, while the equity market typically declines somewhat from its peak around the start of a recession, most of the decline occurs after the recession has begun."

There is no consistency in the stock market before economic downturns, and the market also accidently mis predicted recessions a few times as in 1962, 1966, and 1987 only to quickly recover. The conclusion is that while equity prices are likely to fall once a recession arrives, there is little historical evidence to suggest that equity markets actually lead to recessions. Put in another way, investors should not pre-position themselves for a recession until it's in our midst or actually occurs. In this connection, it's crucial to monitor what is going on in the economy by following NowCasting models like the one used by the Atlanta Fed, NY Fed and Cleveland Fed, leading indicators published by the Conference Board and E.R.C.I., surveys of business confidence and consumer sentiment constructed by the University of Michigan, Bloomberg and Gallup, and indices of financial condition printed by Goldman Sachs

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and the St-Louis Fed. Lastly, we have a variety of proprietary trackers dealing with valuations, monetary policy, financial markets and economic imbalances. One should take note that even if the yield curve inverts, a recession does not immediately follow as we demonstrated above. There has been a 21-month gap on average between inversions and recessions since 1978 and the equity market returns almost 13% in the months between. As it turns out, the “Rule of 20” strongly suggests that there is about 12 % of juice left in stock markets. Indeed, the stock markets could surprise all of us to the upside, especially if trade disputes cease or moderate. The market has a six-month long base and earnings growth and buybacks have never looked better. According to several technical analysts that I know well, the extended trading range has the potential to push the S&P 500 higher to 3000 plus. The technical factors are set for a breakout. A good way to measure how much optimism there is the system, is by calculating the ratio of the S&P 500 to gold. The theory behind this ratio is that stocks represent collective human endeavours while gold has nothing to do with the human effort to get ahead. If investors are piling into gold and avoiding equities, it means that they have more confidence in a do-nothing commodity than in the capitalistic enterprise. The peak of this ratio was 5.5x in the early 2000s when the world was widely optimistic about everything (remember the dot.com craze). The bottom was 0.75x in 2001, during the acute stage of the financial crisis when belief was that the global economy was permanently ruined. Today, the ratio is 2.25 and rising, even with all that is going on in the world. This combination of gold wilting and the S&P bumping near aall-time highs speaks well of market confidence. Interestingly, if one was to run the numbers over an extended period of time, one would find that the S&P 500/Gold ratio moves positively with productivity. As the ratio rises so does productivity. This coincidently agrees with our proposition that productivity is on the rise which should be good for those who own risk assets.

What’s Going on Right Now: The U.S

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 4.5%, up from 3.8% two weeks ago. The Cleveland Fed’s Inflation-Now-Casting model is estimating that Core PCE Inflation will show an annual running rate of only 2.0% for the period under consideration, down from 2.2% three weeks ago. According to Moody’s Analytics, the chance that the economy will be in a recession in the next six months is 15%, far away from the critical threshold of 35%. While credit models have tightened of late, indicators of financial stress and of monetary conditions as reported by the St-Louis Fed and others are still in good standing. Palos calculated on July 19 that 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. If it turns out that some kind of trade agreement is reached the bull run will resume. Look at advances versus the declines. We see many more advances, a telling sign that we are getting a bullish setup says Leon Tuey.

The Global Energy Complex

Palos’ estimated marginal cost of producing oil is $55 a barrel and new research suggests that it may be as low as $50 as we elaborated in last week commentary. At the the of this writing the spot price for a West Texas barrel of oil was $68. That is $13 more than it should be. The speculative fear that the oil supply was now likely to meet demand for a variety of exogenous factors is dissipating fast. There are several reasons why this is happening.

One, Treasury Mnuchin commented that some importers of Iranian oil may get waivers.

Two, shipment of Saudi oil to the U.S. are rising, up 51% in June

Three, the Trump Administration announced that it may tap into the Strategic Petroleum Reserve (SPR) to help reduce high gas price. The SPR has 660 million barrels of crude stored in empty salt caverns in the southern U.S.

Four, Russia noted that their oil fields could quickly increase oil production by as much as 1 million barrels per day if it wanted too.

Five, China has stepped up to the plate to fund an expansion of Venezuela’s crumbling oil industry, pledging to plow $250 million or 5 billion in favour of increasing and strengthening the country’s oil production.

Six, Libyan ports are reopening and ready to ship oil

Seven, the ratio of oil prices to just about all industrial and metal commodities have gotten out of whack, an unsustainable situation.

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There you have it. It should be noted that Middle East spare capacity is just 1% of global oil consumption (about 2.0 million bpd) and that is not much in a volatile world. Imagine what would happen if the Iranians decided to close the "Hormuz oil choke point." This would disrupt about 17 million bpd in seaborne oil trade. In this connection, there is a tendency for traders to pay a premium price for oil, perhaps not $20 but maybe about $10. It's the rational used by Palos to weight its portfolio in lower leverage and lower cost energy stocks that equal the index-weight and ride the waves in a conservative matter.

Technical Perspectives of the Sevens Report (July 19, 2018)

1. Based on the Dow Theory, the trend for that S&P 500 is bullish with key resistance at 2872 and key support at 2716 —2790.

2. Based on a proprietary model, the trend for Crude Oil is bullish with key resistance at $75.93 and key support at 65.34 — $67.97.

3. Based on another proprietary model, the trend for Gold is neutral with key resistance at $1310 and key support at $1193 — $1217.

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