Issue 31

PALOS

August 2, 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

■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

Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

A Stellar Quarter For Stelco

On August 1, 2018 Stelco Inc (TSX:STLC) announced a very strong second quarter. Revenue came in at $711 million versus the street estimates at $586.5 million. Even thought the company incurred $11 million of cost from the Trump tariffs, the company's EBITDA came in at $175 million beating consensus at $141.6 million. In addition, margins continued to expand as management focusses on efficiency. For example, STLC has added distribution capacity through additional rail cars and has also implemented inventory management tools to alleviate inventory build.

The company generated $145 million of free cash flow during the quarter which brought the company's cash balance to $421 million. As a result of the large cash build, the company declared a special cash dividend of $150 million or $1.69 per share in addition to its regular quarterly dividend of $0.10

Palos is impressed with the quarter, but what is even more intriguing is Stelco's current valuation at 4.6x EV/2019 EBITDA vs U.S. peers at 6.1x. Furthermore, STLC acquired prime waterfront land in Hamilton and has optionality over what to do with it. This might create a significant opportunity in the future and be immensely profitable.

■ Mendel's Option Corner

By Robert Mendel

When will you get assigned on an option? I have been asked this question several times already this week. People assume if an option is in the money it will automatically be assigned. Not true. That only happens at option expiry if you take no action.

An option has two components, intrinsic value and time value and there will always be some time value right up until the end. So unless a stock is very deep in the money, or there is some relevant dividend at play, chances are an option won't be assigned. This gives you plenty of time to make a rational decision.

Let me give you an example. Last summer I received a call from someone who got my number

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.69	-0.97%
Palos Equity Income Fund - RRSP	PAL 101	$6.41	-1.84%
Palos Merchant Fund L.P. (Mar 31, 2018)	PAL 500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL200	$8.76	-18.17%
S&P TSX Composite			2.96%
S&P 500			6.89%
S&P TSX Venture			-17.50%

Chart 2: Market Data*

	Value
US Government 10-Year	2.99%
Canadian Government 10-Year	2.37%
Crude Oil Spot	US $68.96
Gold Spot	US $1,208.00
US Gov't10-Year/Moody BAA Corp. Spread	182 bps
USD/CAD Exchange Rate Spot	US $0.7679

* Period ending Aug 2, 2018

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from an existing client. He told me he sold the Aug 70 puts on ConocoPhillips, a US oil and gas giant, and was now worried because another friend of his told him he would get assigned since the stock was $6 In The Money (at $64). But because there was still $2 of time premium on the option I told him it wasn't going to happen. He hung up and I patted myself on the back that I did a nice thing for someone while expecting nothing in return. (I know, I am special)

Anyway, he called me back apologizing, but his friend said the assignment was imminent. His worry was now full-blown panic since he did not have any U.S money. Again, I mentioned he had time and there were always things he could do anyway, but only when the time was right. His friend however, convinced him he did not have that time and he ended up buying back the put option walking away with a loss. And of course, as murphy's law would have it, the stock reversed and went back over $70. A loss which could have been avoided. The bottom line? If there is time premium on the option you will not get assigned.

And yes, he is a client now.

Until Next time

■ What is New on the Macro Level?

By Hubert Marleau

U.S. GDP for Q2 2018

Last Friday, the Commerce Department reported that the second-quarter GDP rose at the annual rate of 4.1%, slightly more than our forecast of 4.0%. While we acknowledge that this performance is the best in four years and one of the strongest quarterly growths since the great recession, Palos likes to analyze GDP numbers on a year-over-year basis. Our method tends to eliminate irregularities, smooths trends, avoids false interpretations, and make better judgements of what is going on.

Firstly, in the quarter ended June 2018, N-GDP increased 5.3% year-over-year. Inflation accounted for 2.5% of the increase while employment and productivity accounted for 1.5% and 1.3% respectively. It should be noted that for the period under consideration, core inflation increased 1.9% on target with the fed's objective. Productivity-trends were very positive steadily rising from a record low of minus 0.3% in Q1/2016. This robust expansion in productivity will likely continue in large part because businesses are making significant investments in new factories, equipment and research and development. Business investments are up 6.7% representing 15.0% of R-GDP and contributing 33.3% of the percent change in R-GDP. What is particularly important is that these later numbers have been on an upward trend since the end of 2015. During Q4/2015, business investments was down 0.6% representing 13.6% of R-GDP and contributing zero to the percent change in R-GDP. The mindset of market participants is that growth is not sustainable. This is wrong for capital expenditures are not one-quarter wonders since they allow productivity to rise in years to come.

Secondly, in the second quarter of 2018, N-GDP increased 5.3% year-over-year. The transactional money with zero maturity and readily available to spend increased 3.9% signifying that the turnover of money increased 1.4%. It was the third increase in a row bucking decades of falling velocity of money. It's a very encouraging signal that money is not being hoarded as much as it has been and is therefore being spent on goods and services. Rising turnover of money is usually associated with growth without having the need to pump large amounts of printed money into the financial system.

Thirdly, the economy does not appear to have any serious imbalances that could tilt the economy toward a recession. In the quarter under analysis, the net exports deficit was 2.7% of N-GDP, far away from the problematic ratio of 5.0% and below the IMF guideline of 3.0%. Spending on energy as a percentage of N-GDP was 1.6% also far away from the questionable ratio of 2.5%. Additionally, cyclical expenditures who are naturally sensitive to interest changes like residential construction, consumer spending on durables and business capital formation account for 27.1% of growth, again some distance away from the 30% considered pushy.

Fourthly, personal disposable income increased at the annual rate of 5.1%, the best increase in years and almost 60% in real terms (2.9%). 6.8% of disposable income was saved. Consumers are in much better shape than they have been in years with rising income and stable savings. This augurs well for future spending. Economic fate depends on U.S households' wherewithal to spend and carry the economy. And, this one big data point is on the plus side, paychecks are growing, job security and transferability are very good and income taxes are down. What is also remarkable is that consumers are spending their money in a frugal manner either by finding alternatives or substitutions, for only 1.9% is eating into the 5.3%

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increase in personal income. What I like about real personal disposable income is that it's one big number free from the influences of inventories and international trade. Interestingly, inventories subtracted 1.00 percentage point from the quarter GDP growth rate while net exports added 1.06 percentage point. Two very volatile categories that basically netted themselves out.

Lastly, the economy is very profitable and macro-valuations are fair based on historical standards. According to our calculations, corporate profits before and after-taxes registered annual increase of 6.5% and 15.7% respectively in Q2/2018. Because there is a close relation between the stock market, changes in corporate profits and between long term interest rate and changes in N-GDP, we index the ratio of the S&P 500 with after tax profits and that of ten-year treasury yields to year-to year percentage changes in N-GDP. It's a way to determine if valuations of stocks and bonds approximately reflect the broad performance of the economy. In this connection, the S&P 500 (2819) is about 7.5% cheaper than it should be and yields on ten-year treasuries (3.00%) are 50 bps too low.

THE BOTTOM LINE is that the numbers are just too good to think that nothing has happened in the economy; it does make us think that my prediction two-plus-two economy should be adjusted upward. The pace of the economy has been trending up in a steady fashion since Q2/2016 with corresponding upward trends in productivity gains and money turnover. There is talk of 4.0% real growth for the foreseeable future. The recent July batch of economic data points that feed high frequency models show estimates for real growth of 4.7% and for core inflation of 1.8% for Q3/2018. That is probably too good to be true for the quarter has not yet ended and more data is coming. My calculations, which partially rely on surveys of credit managers across the manufacturing and service sectors, are signaling that the U.S. GDP will downshift from 4.0% to 3.0%. Unlike other economists who based their thinking on solely hard economic data, I watch a lot of soft business surveys to a get a feeling of street perception to blend with hard data. Additionally, I am a bit more cautious than other market economists because I see a few small cracks in the housing market. Overall activity is good, but the sector is slowing down. New and existing home sales are down and as are housing starts and mortgage applications all from elevated levels. In this regard, and given our conservative bias, I am going with 2.5% for growth and 2.25% for inflation and will compute future stock and bond valuations on such a scenario. As an aside, the commerce department will release its initial estimate of Q3/2018 on October 26, just 11 days before U.S voters go to the polls, making it a key test of whether high growth appears to sustainable and is being felt across the country.

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

By the time you read this, the Bureau of Economic Analysis will have reported on how well the U.S. economy did in the June quarter of 2018. High Frequency Economic Models have record growth estimates ranging from 2.8% (NY Fed) to 4.5% (Atlanta Fed). We like Moody's model and its tracking 4.0%. The Inflation NowCasting model of the Cleveland Fed has placed its bet on a 2.0% inflation rate, I think that is a bit low. Preliminary economic and financial data, soft and hard, and leading indicators like the weekly ERCI are suggesting that economic growth should moderate to levels that we have been accustomed too since 2009, 2% for growth and 2% for inflation. Moderate growth brings stability and is generally good for investors as it avoids the creation of economic imbalances that can bring about recessions. Given the relatively slow pace of the current expansion, this expansion cycle will likely last much longer. The cumulative growth of this cycle is 30%. It's not only the lowest on record since the end of WWII, it's way below the average of 65%. At this time, recession risks for the coming year are low. Moody Analytics clocks a 15% probability and the NY Fed has it at 12.5%. As a matter of fact, weekly fast moving data like production of lumber, coal, steel and electricity are all up while railway carloadings and mortgage applications are positive. Investors are too nervous paying too much attention to the narrowing yield curve. They should also watch job creation, productivity gains, core inflation trends, credit expansion, earnings reports, and housing starts for even an inverted curve does not bring recessions unless the aforementioned factors turn red. At this point, not one of these factors are ugly or negative. For example, there has never been a recession with a prior fall in earnings and typically the decline has to be more than 14% and sometimes it does not happen unless the fall is more than 55%. There were 11 recessions since 1950, earning declines before a recession occurred 21% of the time according to Credit Suisse.

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Monetary Policy Around the World

This was a busy ten days for worldwide monetary policy as a combination of the ECB/BoJ/FED/BOE reported. Bottom Line: Central Banks are slowly but gradually removing some monetary accommodation in response to either shrinking dollar abundance or mild inflationary pressure

What Is Going On With The Bank of Japan (BoJ):

Defying market expectations and quashing a week of speculation that the BoJ was mulling changes in its monetary stance, the bank stuck with its ultra-easy monetary policy. No surprise for me because the Palos Monetary policy index for Japan clearly indicates that Japanese monetary policy should be easy, very easy. The bank acknowledged that inflation will likely fall short of its 2.0% goal until 2021. Accordingly, the BoJ has dug in giving little evidence that it's about to change control over the yield curve and pledging to keep interest rate in the short end negative and bonds yields near zero for an extended period of time. Nevertheless, the BoJ said that it would tolerate bond yields deviating as much as 0.2% and apply negative rate on fewer reserves in the hope of giving some financial relief to the banking system. What it means is that Japan, through carrying trades, will provide liquidity to the world monetary system and in turn tend to put a lid on U.S. bond yields. The spread between ten-year bond yields is 2.95% in favour of the U.S.

What Is Going On With the Fed?

The FOMC held a two-day meeting and was uneventful for it kept the target range for federal funds rate unchanged at 1.75% to 2.00%. There was nothing in the official statements that would lead us to believe that the Fed plans to increase raises more than twice this year in September and December.

What Is Going On With the Old Lady?

The Bank of England (BOE) raised its benchmark interest rate for the second time in a decade to 0.75% from 0.50%. Consumer-price growth is currently running at 2.4% above the BOE's 2 percent target and it has outdone concerns about Brexit and global trade disputes.

What Is Going On With the ECB?

The Governing Council of the EDB decided to keep the interest rates on main refinancing operations, on the marginal lending facilities, and on reserve deposits unchanged at 0.00%, 0.25% and -0.40% respectively. This will last through the summer and for as long as necessary to ensure the continued convergence of inflation to levels close to 2%. The ECB will make net purchases of bonds under the asset purchase program (APP) but at a reduced rate until it ends in December. It should be added that the ECB will maintain favourable liquidity conditions and an ample degree of monetary accommodation for as long as necessary.

What Is Going On In Canada?

I have revised my estimate for Canadian GDP growth for the second quarter of 2018 to an annual rate 2.75% from our previous forecast of 2.5%. National output for May was strong and broad manifesting solid underlying domestic demand. Consequently, this strength is increasing the odds that Canadian monetary policy will more closely match that of the U.S. and partially explains the current rise in the Loonie towards 77 us cents.

Technical Perspectives of the Sevens Report (July 26, 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 2750 —2794.
2. Based on a proprietary model, the trend for Crude Oil is bullish with key resistance at $74.21 and key support at 64.34 — $67.03.
3. Based on another proprietary model, the trend for Gold is neutral with key resistance at $1290 and key support at $1173 — $1225.
4. Based on a proprietary model, the trend for 10-year treasury yield is bullish with key resistance at 3.00% and key support at 2.82% — 3.00%

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