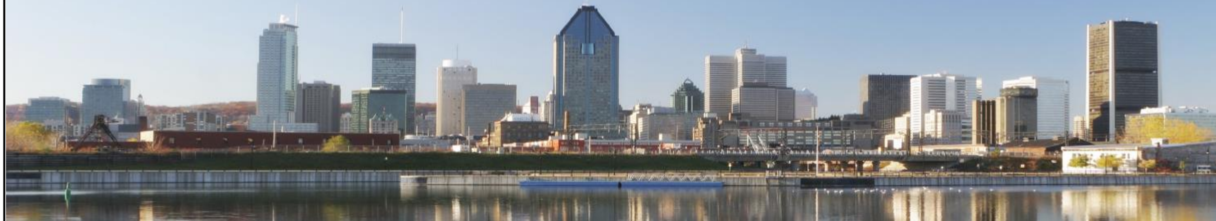
Issue 34



PALOS

August 23, 2018

To subscribe to our Newsletters
www.palos.ca/register

■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

William Mitchell
Portfolio Manager & Equities 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

Disclaimer: This publication is proprietary to Palos Management Inc. (along with its affiliate Palos Wealth Management Inc., "Palos"). This publication may be copied, downloaded, stored in a retrieval system, further transmitted, reproduced, disseminated, and/or transferred, in any form or by any means, but only as long as it is unaltered and attributed to Palos. This publication and its contents may not be sold or licensed without Palos' written permission. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made or implied regarding accuracy or completeness. The information provided does not constitute investment advice and it should not be relied upon on as such. If you have received this communication in error, please notify us immediately by electronic mail or telephone. This document may contain certain forward-looking statements that are not guarantees of future performance and future results could be materially different. Past performance is not a guarantee of future performance. "S&P" is a registered trademark of Standard and Poor's Financial Services LLC. "TSX" is a registered trademark of TSX Inc. The Bloomberg USD High Yield Corporate Bond Index is a rules-based, market-value weighted index engineered to measure publicly issued noninvestment grade USD fixed-rate, taxable, corporate bonds. To be included in the index a security must have a minimum par amount of 250MM.

Palos Weekly Commentary

■ Palos Funds

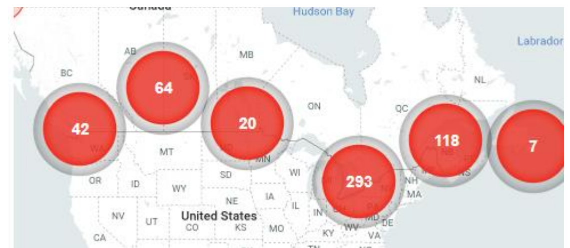
By Charles Marleau

Loblaws: A Defensive Name With Growth Potential

Loblaw Companies Limited (TSX: L) is a leading Canadian retail and wholesale food distributor. The company trades at an attractive valuation of 6.5X EV/EBITDA. There are a few catalysts that I think make L more attractive than other Canadian grocers.

1. L has consolidated their loyalty program, where PC Plus and Shoppers Optimum loyalty have been combined. This gives L an advantage over their competitions as customers have more choice.
2. L has made a big push on home delivery. They have a partnership with Instacart in Toronto and Vancouver and continue to invest in their Click & Collect service.
3. L is making a big push via digital campaigns on social media.
4. The company is adding more Presidents Choice brand products to Shoppers Drug Mart.
5. The medical cannabis opportunity for Shoppers can be very significant. Estimates vary from $150 mil to $400 mil of additional revenue. This would have a significant impact on same stores sales.
6. The recreational marijuana market is another large opportunity. A few weeks ago, the Ontario government announced that it will allow privates stores to sell marijuana on April 1, 2019. L has not announced any plans to partake in the market, but they are at a great advantage to any competitor. They have access to prime real estate via Choice Property REIT (TSX: CHP-U). It would not be surprising to see L come out with a new brand of recreational marijuana stores.

(CHP-U List of Properties)



Further to the above catalyst, I'm also expecting food inflation in the coming 12 months. This

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.71	-0.11%
Palos Equity Income Fund - RRSP	PAL 101	$6.42	-0.98%
Palos Merchant Fund L.P. (Mar 31, 2018)	PAL 500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL200	$8.53	-20.24%
S&P TSX Composite			2.56%
S&P 500			8.20%
S&P TSX Venture			-17.63%

Chart 2: Market Data*

	Value
US Government 10-Year	2.83%
Canadian Government 10-Year	2.26%
Crude Oil Spot	US $67.89
Gold Spot	US $1,184.90
US Gov't10-Year/Moody BAA Corp. Spread	191 bps
USD/CAD Exchange Rate Spot	US $0.7645

* Period ending Aug 23, 2018

PALOS

August 23, 2018

To subscribe to our Newsletters
www.palos.ca/register

■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

William Mitchell
Portfolio Manager & Equities 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

should translate into better margins for L. For a defensive name, L has many catalysts and comes at an attractive valuation.

■ Mendel's Option Corner

By Robert Mendel

One thing is for certain, the world is for the birds. And speaking of birds let's talk Turkey. The Turkish Stock Market ETF (TUR) has been hard hit with all the talk surrounding sanctions of the NATO ally for not releasing an American Pastor.

TUR had a 52-week high of $47.13 and was trading around $30 when news of the sanctions broke bringing the share price down to $20.50. This created an opportunity. Not wanting to stick around for a longer period I sold a short-term September 18 put for .75 cents, a 4.2% return in 35 days if it stayed above my strike. Also, I had a 12.2% downside protection to still maximize my profit. Of course, that's an 'if' and a big one at that as the market had been falling precipitously. (I amaze myself with my big words) But I thought it was at the point where the reward was worth the risk. I will keep you posted.

Let me give you an update on the Tesla position I wrote about in the August 9 Issue. If you recall I am short the Jan 400 calls and I still am. What I haven't written about is that I was also short the August 24 340 calls (sold for $10) and the October 360 calls (sold for $10.45). When the stock opened in the low 290s a few days ago I covered (bought back) the August 340 calls for .85 cents, a nice profit. I figured it wasn't worth waiting for that last bit when anything could happen, even with just 5 days to go. But I am still short the other two positions with time on my side. So although it is looking much better now, two weeks ago it was not. But I hung on and it paid off.

Speaking of Turkey, I think I'll go eat…until next week.

■ What is New on the Macro Level?

By Hubert Marleau

Canadian Inflation

Inflation surged in July across a broad range of categories. The consumer price index rose 0.5% between June and July. leaving it up 3.0% on a year-ago basis. This is a seven-year high and above the BOC's target of 2.0%. The new pace marks a considerable acceleration from the 2.5% and 2.2% inflation respectively registered in June and May. Bond and foreign exchange traders took notice that the new pace is significantly above the 3-month average of 2.6% and the 12-month average of 2.0%. Short-term government bond yields pushed higher and the Loonie suddenly appreciated upon release of the news. The odds for an earlier than expected rate hike in September have considerably risen. However, the next move is more likely to take place in October.

The higher rate of inflation was fueled by gasoline prices and air-transport costs rising 25.4% and 16.4% respectively. The BOC's core price measures which strips out volatile items like food and energy were rather timid. The CPI-common was unchanged posting 1.9% annual gain. The CPI-median held at 2%, while the CPI-trim inched tolerably higher to 2.1%. The impact of U.S. tariffs on food and other products has been mild and low. Statistics Canada estimated that Canada's retaliatory tariffs on U.S. goods caused only a 0.07% increase in the overall CPI. From this we can absolutely concluded that there is a good chance that inflation could cool down over the coming months. Indeed, inflation expectations are lower than they were a month ago reflecting the steep 12% decline in the CRB Spot Commodity price index since mid-June.

Moody's Analytics' Take on NAFTA

Moody's expects the impact of the steel and aluminum tariffs to be limited. The U.S, does not have the capacity to produce enough steel and aluminum to meet demand. Consequently, U.S. producers, who use Canadian metals as inputs, have tuned their equipment to work optimally with the specific grade and quality being provided. Finally, the tariff appears to be a plot to put pressure on NAFTA renegotiations. A successful renegotiation would result in the removal of the tariffs. Given that the switching costs to U.S. producers are too high, it is unlikely that the tariffs will remain intact for long leaving an optimistic outlook for Canada's mining industry.

The U.S. Debt Overload

Last Friday, about 60 people attended a Trump Fundraising affair at the Southampton home of Howard Loeder, the chairman of hot dog company Nathan's Famous. I knew the former chairman when I spent the winter season in Fisher Island, Florida. I'm not surprise that as much as $3 million was raised for the Trump Victory Committee. That's not what was important, it was what President Trump said. He commented that he

PALOS

August 23, 2018

To subscribe to our Newsletters
www.palos.ca/register

■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

William Mitchell
Portfolio Manager & Equities 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

expected Jerome Powell to be a cheap-money Fed chairman. Instead, Powell has raised interest rates twice. On Monday, Trump extended his personal criticism of Powell's performance in an interview with Reuters. Trump asserted that other countries have been helped by Powell's actions in trade disputes with the U.S. during a period of time when some help by the Fed would have been great. There is absolutely no evidence in the accusation that China and the European Union are currency manipulators. In fact, the president's accusation was presented without explanation or substantiation. The Treasury Department hasn't officially named any country as a currency manipulator in the April semi-annual report on foreign-exchange policy. Moreover, the federal funds rate is 2.00%. It's running at about the same pace as the Fed's main inflation gauge, the personal consumption deflator, which is up 1.9% year-over-year through June. Real interest rates are essentially nil.

Therefore, one may wonder about the economic significance of President Trump's criticism of Fed Chairman Powell. Contrary to popular opinion, the main economic risk on the horizon does not come from international trade disputes or the tribulations of emerging market assets. In my judgement, it's about the "U.S. Debt Overload." This comes amid ongoing questions about the prospective rundown of the Fed's balance sheet and the expected hikes in the policy rate. This collides with the deluge of treasury supply necessitated by the tax cuts and spending bills. While I acknowledge that there are geopolitical headwinds like the trade war, the various diplomatic rows and threat of financial and economic sanctions, as a market economist, I feel obliged to talk about the enormous debt of the U.S. government. It will soon become the narrative of the day. So far, nothing bad has happened despite immense fiscal deterioration. Firstly, the debt-to-N-GDP ratio has more than doubled in less than twenty years, from 33% in 2000 to 78% in June/18. The ratio is on course to reach 100% in less than ten years. Secondly, the estimated budget deficit for fiscal 2018 is $850 billion representing 4.3% of N-GDP. The deficit is forecast to surpass the 1.1 trillion by 2019. Thirdly, Treasuries held by foreign investors total $6.3 trillion today accounting for almost 45% of the $15.4 that is outstanding, the lowest proportion since November 2016. Foreign treasury ownership has steadily declined from its peak of 55% during the 2008 financial crisis. Lastly, the Federal Reserve is reducing its Treasury debt holdings and analysts think that the Fed could continue to allow its Treasury bond portfolio to shrink to half its $2.6 trillion size. We have a reduction in what was once a steady source of demand from the Fed and foreigners at a time when supply is on the rise. In this regard, the Trump administration would like to avoid the burden of higher borrowing costs for the federal government. It's difficult to figure out the impact of rising interest rates on borrowing costs for the relationship is far from linear, but a 1% increase in the policy rate could bring about a $30 billion increase an additional cost per year. That's effectively a perpetual decrease of 0.35% of the R-GDP. A recent IMF analysis noted that among advanced economies, only the U.S. expects an increase in the debt-to-GDP ratio over the next five years. Despite today's shrill discord between the Republicans and Democrats, the political class is more divided by class interest than it is divided by economic ideology. From left to right, they both have a permanent incentive to run deficits. The two long-standing tenets of the two major political parties impede the ability of the government to re-establish sound fiscal conditions. Republicans believe low taxes are key to growth, and Democrats believe that maintaining entitlements is necessary to improve living standards. They both tax the population less than what it cost the government to provide goods and services. It works only as long as tomorrow is another day. However, there comes a time when saddling the future with the servicing of the debt can only suppress growth A smart economist named Rogoff figured that the tipping point is reached when the ratio of debt to GDP reaches 125% and the budget deficit to GDP stays at 5%. That is the point when a country can no longer kick the can down the road. In other words, the acceptance of ever increasing national debt is a function of the general expectation of ever-rising productivity. Tax revenue as a % of N-GDP is about 16.5%. In a full-employment economy combined with 2.0% productivity gains, tax revenue can be as high as 18.5% of N-GDP. If tax revenue were at that level for the coming decade, debt would be $3.2 trillion lower and the 10-year fiscal gap would be halved. I trust that the current upward trajectory in productivity trends will last. If the Americans take practical steps, implement technological advancement, and invest their surplus resources, political stupidity will not undo them.

Investors should note that gold is basically a hedge against a monetary mistake and/or a government fiscal mistake. The bottom line is that false accusation of currency manipulation and interference with central bank independence at a time when the economy is at full employment and

PALOS

August 23, 2018

To subscribe to our Newsletters
www.palos.ca/register

■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

William Mitchell
Portfolio Manager & Equities 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

on target with inflation, could be positive for gold. On one hand, the debt overload dictates lower interest rates while the state of the economy dictates higher rates. Consequently, if the surge in productivity gains is not sustained, a policy mistake becomes a possibility. Given the cheapness of gold relative to most other forms of investments, some exposure to bullion and/or gold could be seen as a good hedge.

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

At their last FOMC meeting. the Federal Reserve Bank signaled that another rate hike is likely in September if the economy performs in line with current expectations. It is performing well. High frequency models are estimating that R-GDP growth will top the annual rate of 3.5% in Q/3. However, I'm of the opinion that in 2019, the Fed will probably pause the path to higher rates and, in turn, be more macroprudential than countercyclical. This means that Fed officials may decide to govern the amount of extra equity and cash banks are supposed to hold. A higher capital buffer would help the financing of the budget deficits, permit rates to stay, and reduce the risk of financial instability.

What's Going on Right Now: Canada

There is no shortage of negative headlines in Canada. Fortunately, there is a silver lining for the risk/reward ratio has dramatically improved. The TSX index adjusted in U.S. dollars is 437x the S&P 500. It was 500x at the end of December 2018. Of this 12.6% decline, the exchange value of the Loonie and Canadian stock prices accounted for 3.2% and 9.4% respectively. Currently, the forward EPS estimate for the TSX is running at 19% compared to 22% for the S&P 500. The combination of strong earnings and lackluster stock performance has brought about an important reduction in the forward P/E ratio. Presently, the forward P/E ratio is only 14.5x, that below the five average and in line with the 10-year average.

Technical Perspectives of the Sevens Report (August 23, 2018)

1. Based on the Dow Theory, the trend for that S&P 500 is bullish with key resistance at 2891 and key support at 2750 —2861.

2. Based on a proprietary model, the trend for Crude Oil is bullish with key resistance at $69.04 and key support at 61.95 — $67.83.

3. Based on another proprietary model, the trend for Gold is neutral with key resistance at $1200 and key support at $1133 — $1194.

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 2.76% — 2.82%

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