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August 30, 2018

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

NAFTA Uncertainty

The Canadian market has been suffering from NAFTA uncertainty for the past twelve months. One industry has been affected more than others and it's the auto parts industry. However, there has been significant news on NAFTA this week. It all started on Monday with the US and Mexico bilateral agreement. This announcement gave significant optimism that a joint agreement with Canada is to follow. Since Monday, all three leaders have spoken with a positive tone that an agreement could be completed by the end of the week. Canada and the US are both demonstrating the willingness to negotiate and make concessions. I'm of the opinion that an agreement can be reached in the coming days.

The aggressive sell off in auto parts companies has brought an attractive multiple to the industry. One name that the funds have been accumulating for the past 3 weeks has been Linamar Corp (TSX:LNR). Since the beginning of the year LNR is down 25% and has been trading near its book value. On EV/EBITDA LNR is trading 4.12x which is well bellow its historical mean. If an agreement is reached, which I believe has a high probability of occurring, the stock can easily rerate by 30% using its historical mean valuation. However, the best data point is the CEO Linda Hasenfratz, who she purchased 17,200 shares at $57.70 on August 28, 2018 for close to $1 million.

In conclusion, I believe that LNR is a compelling investment at these levels. We have positive momentum on NAFTA, the CEO is buying shares, and the valuation is attractive. At this stage the upside outweighs the downside risk.

■ Mendel's Option Corner

By Robert Mendel

I walked into the trading room and said, "I don't know what to write about this week." Charles Marleau, the head honcho, said "write about how good looking I am." Great idea, I thought. The world must know about this golden boy.

And then it occurred to me, I need to mention the gold position I initiated, something I alluded to a few issues ago. JNUG is a junior 3x leveraged gold ETF, a very volatile instrument and certainly

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.73	0.10%
Palos Equity Income Fund - RRSP	PAL 101	$6.43	-0.77%
Palos Merchant Fund L.P. (Mar 31, 2018)	PAL 500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL200	$8.68	-18.84%
S&P TSX Composite			2.93%
S&P 500			9.91%
S&P TSX Venture			-15.19%

Chart 2: Market Data*

	Value
US Government 10-Year	2.86%
Canadian Government 10-Year	2.27%
Crude Oil Spot	US $70.05
Gold Spot	US $1,200.00
US Gov't10-Year/Moody BAA Corp. Spread	189 bps
USD/CAD Exchange Rate Spot	US $0.7703

* Period ending Aug 30, 2018

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not for the faint of heart. On August 24 I bought the shares at $8.25 and simultaneously sold the Sep 9 calls for .42 cents bringing my cost down to $7.83 with a cap of $9. I wanted to stay very short (27 days) because of the volatility. Remember, the highest percentage premiums are very often on the shortest-term options. As of this writing, an at the money call option offers a 6% return just for 23 days (crazy numbers if you annualize it) So my plan is to keep rolling over if I can and if it runs above $9 then I walk away making 15% in 27 days ($9-$7.83= $1.17/$7.83). Will keep you posted.

Because of the higher degree of risk, I used smaller amounts of money. Remember this is not Johnson and Johnson, it is a leveraged ETF. So be careful, be wise, and most of all let's all strive to be as good looking as Charles.

■ What is New on the Macro Level?

By Hubert Marleau

The Saving Grace of U.S. Productivity

The maximum rate of long term growth is basically determined by the rate of population growth, or more specifically, workforce growth, and how productive those new workers are. Given that the U.S. economy is operating at full employment and generating target inflation, profitable growth can only be extended with increases in productivity because demographics will be trending lower over the coming years. However, the aging process is crawling because there is astonishing progress in gerontology, in cures for medical ailments, and in the treatment of the elderly. A growing share of people over 65 years old are not abandoning work. Assuming that the trend growth in the workforce will roughly be 0.75% to 1.0% per year, a reversal in productivity growth to 2.0% to 2.25% will be necessary if the economy is to experience sustainable growth of 3.0% over the long-run. In this connection, it is imperative for investors to closely track what is going on with productivity. Productivity is a miracle drug for it can solve a multitude of economic and political problems as it tends to decrease inflation, increase growth, ease the burden of debt, lower interest rates, raise wages and increase profit - all at the same time.

Thankfully, U.S. worker productivity has been accelerating since the first quarter of 2016. During the June quarter of 2018, productivity was running at the annual pace of 2.7% for a year-over-year increase of 1.3%. The probability is high that productivity will registered a y/y increase of 1.7% in Q3/2018. From the first quarter of 2016 to the second quarter of 2018 R-GDP grew 5.6% and productivity accounted for 55% of the growth compared to only 33% of the 15.6% of the growth registered in the 2010-2017 period. Currently, there are many favourable factors in place like deregulation, high household saving rates, solid corporate profits, cheap capital, high-quality labour, improved capital depreciation allowances and tax incentives. Since 2009, business investment has accelerated, steadily growing faster than R-GDP. During Q2/18, business capital formation accounted for 15.0% of the GDP compared to only 11.3% when the expansion began in mid-2009.

In fact, the market is ready for the application of new technologies to production, to experiment with revolutionary ideas, and to efficiently mechanize businesses. Many businesses are adopting machine learning capabilities to power new business models creating higher revenue streams and cost efficiencies. The transformation of these new business models is built with software mechanisms that collect and process data in a "closed loop" center. This software is now found in just about every industry, including logistics, agriculture, and services. The implications on productivity of the rise of these model-driven businesses are both high and cumulative. Model-driven business is built around a system that continuously improves the model to achieve higher productivity, higher sales, lower costs and higher profits. Once you have these models in place, the incremental cost of processing more and more business becomes negligible. The economies of scale are humongous. These revolutionary models are increasingly funded with a large number of billionaires who can easily afford the business and financial risks.

Jackson Hole Recap

Jerome Powell revealed that "the Fed is in some kind of balancing act between the risk of the economy overheating and limited evidence for accelerating wages and inflation." He sees a current path of gradually raising interest rates as the approach to take on both of these risks. While inflation has recently moved up to 2.0%, he sees no clear sign of an acceleration above 2% and does not seem to be concerned with an elevated risk of overheating. If I was to accept Powell's assessment as credo, the recession risk would likely remain low for many more quarters. The cost of money is nil and below the estimated neutral rate and the yield curve has not inverted. It now appears that there will two more rate hikes in

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2018 and only one in 2019. This would take the federal funds rate to 2.625%. Assuming that long rates were to stay where they are now (2.85%), the yield curve would still be positive, the cost of Fed-money would be below the neutral rate (2.75%) and the real rates would mildly positive, way below the historical norm. I wrote last week that the Fed may employ more macroprudential measures and QT than macro-cyclical policies like interest rates to control the risk of too much inflation. In this connection, an inverted yield could be averted, the spread, the neutral and the policy rates could remain positive and real rates could stay positive, reducing further any recession risk.

What's Going On: NAFTA

By the time, you get to read this commentary, we shall all know if Canada will meet the Friday deadline to sign a new NAFTA deal with the U.S. and Mexico. All Canadian markets expect that a deal will be signed. The Canadian dollar is up suggesting the elimination or reduction of export duties. Interest rate differentials between the U.S. and Canada have narrowed suggesting that it will be easier for the Bank of Canada (BOC) to conduct monetary policy. The Canadian stock market, particularly the auto sector, is up suggesting that supply chains will remain intact.

Canada was given a choice to "get on board with the U.S.-Mexico Trade Deal and give up the dairy protectionism right and or lose with automotive tariffs that President Trump will surely immediately impose." Keeping NAFTA together is critically important. The question then becomes whether scrapping or amending the dairy/egg/poultry cartels is too much of a political PMO to pay. I don't think so. Are we going to sell out all Canadians for the benefit of 16,000 farmers. It should be noted that in the Trans-Pacific Agreement, Canadian officials agreed to end the dairy cartel within 10 years. So what is the big deal? Perhaps, in a weird way, President Trump is offering the government a solution to rail in the duties on dairy products. The good news is that markets say we do not have too much to worry about, a deal is in the offing. The deal will not add up to much, the changes to the auto-sector are minimally important and approval through Congress would be smoother with a three-way deal rather than through a bilateral agreement. The bottom line is that investors are cynics, believing that President Trump is full of fury.

The FT says it well: "Investors regard NAFTA as a tail risk and not as a central case." The latest league table of tail risks put together by the Bank of America Merrill Lynch ranks the Trade War as the biggest tail risk. The other risks like Quantitative Tightening, a China Slowdown, Credit Events and a Democratic Sweep are considered as very small risks. The markets effective expected value of NAFTA may be too low. Canada has a lot to lose from a hostile trade policy with the U.S.. Consequently, an awful lot of responsibility is falling on the shoulders of the Canadian foreign minister Chrystia Freeland. NAFTA is very popular with Canadians. She's on the spot between a rock and a hard place. It looks like she has to "take-it-or-leave-it." She needs to placate President Trump, keep Canada in the free-trade pact, and come out looking like a winner. It means 1) preservation of a dispute-resolution mechanism that Trump dislikes, 2) acceptance of a favourable compromise on the five-year sunset clause to a six-year review, 3) protection of key exportable goods from U.S. tariffs, 4) avoidance of new levies on the Canadian auto industry, 5) negotiation of a satisfactory compromise on agriculture and dairy products, and 6) maintenance of friendly relations with the free trade Republicains who have close ties to US businesses. The fact is that the tenor between Canada and U.S. is negative and the power relationship is clearly lopsided. The Macdonald-Laurier Institute, as Ottawa-based think tank, said that Canada shoulders some of the blame for failing to understand the changing U.S. political landscape and adjusting accordingly. "Canada may not like Trump, but that's irrelevant" wrote the Institute. Canadian dependence on the fortunes of the U.S. combined with uneven commercial prospects will be used as leverage. Put simply, Canada wants to preserve the existing dispute-resolution system and the U.S. wants to gain more access to Canada's dairy market. Which of the two would cause more material injury over the long-term? I say the lack of a fair dispute-resolution mechanism.

Interestingly, the Bank of France just published a paper examining tariffs placed on cereals in 1892. The authors argued that the protectionist measures shifted relative prices in favour of agriculture and away from industry, reducing France's potential growth, delaying industrial productivity, and encouraging fertility where cereal production was high and school enrollment was low. The study may be of no relevance when it comes to Canada, but, it shows that tariffs and subsidies have long-term negative effects on general welfare.

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U.S. Corporate Profits

Many investors are predisposed to thinking that an economic contraction is around the corner. Nevertheless, measures of financial stress and of recession risk are clearly not pointing in that direction. It's hard to figure out why. Consumer confidence is soaring by all measures. Meanwhile, corporate profits are growing fast (net cash flow totaled $2,565.0 billion in Q/2, up 16.9% y/y) and personal savings were revised up to $1054.3 billion in Q/2, substantially higher than the pre-crisis period and up 6.5% y/y. Americans are saving a record 6.8% of their personal disposable income. Consequently, businesses and consumers have a lot of untapped spending power at a time when banks are loosening their credit standards. The current economic expansion still has long legs. Those who think that the profit increases are solely the result of tax cuts are wrong. The WSJ reported that sales by S&P 500 companies grew 9.5% y/y in the June quarter, the fastest rate since the fall of 2011. The fact is that the robust business environment helped drive profits beyond the effect of tax cuts and share buybacks. Private savings from the household and corporate sectors are at record levels, assuring investors that businesses will continue boosting investment to meet strong domestic demand and to replenish inventories.

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 2984 and key support at 2810 —2910.

2. Based on a proprietary model, the trend for Crude Oil is bullish with key resistance at $79.49 and key support at 64.15 — $69.83.

3. Based on another proprietary model, the trend for Gold is neutral with key resistance at $1243 and key support at $1159 — $1206.

4. Based on a proprietary model, the trend for 10-year treasury yields is bullish with key resistance at 2.94% and key support at 2.77% — 2.88%

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