Issue 36

PALOS

September 6, 2018

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Palos Weekly Commentary

■ Palos Funds
By Charles Marleau

Charles was at an energy conference all day and was unable to write a commentary. This column will return next week.

■ Mendel's Option Corner
By Robert Mendel

So I walk into the trading room and asked when the deadline was for this week's newsletter. Today I was told.

Now that doesn't leave me with much time and like last week I wasn't sure what to write about and said so. Another person said "this time write about how good looking I am."

I looked out the window into the sky with the feeling that I am not in the money management business but a reporter for a beauty contest with jealous contestants. And then I saw the plane. A Boeing 767. And it came to me, tell the world about my latest Boeing play. I say latest because I am already long the stock and have sold out of the money covered calls against it. What I want to share however is a twist on the desire for having more upside while keeping some downside protection. It is like buying the shares without actually buying the stock. So here it is.

Yesterday (Wednesday Sept 05) with the stock at $345 I sold an in the money January 370 put for $34. What does this mean? If the stock stays here at $345 by the January expiry the option will be worth $25 ($370-$345) leaving me with a $9 profit. If it rallies above $370 (my strike) like I am hoping, the profit would be the whole premium collected ($34) And if the stock falls I have some downside protection to my break-even point of $336.

Let's see how this plays out. More importantly I hope there are no more jealous contestants.

■ What is New on the Macro Level?
By Hubert Marleau

The Economics of Revoking NAFTA

Thucydides warned us 2500 years ago that questions of justice only arise when there is equal power to compel, adding that in terms of

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.56	-1.68%
Palos Equity Income Fund - RRSP	PAL 101	$6.32	-2.41%
Palos Merchant Fund L.P. (Mar 31, 2018)	PAL 500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL200	$8.52	-20.35%
S&P TSX Composite			1.30%
S&P 500			9.09%
S&P TSX Venture			-16.46%

Chart 2: Market Data*

	Value
US Government 10-Year	2.87%
Canadian Government 10-Year	2.23%
Crude Oil Spot	US $67.89
Gold Spot	US $1,199.00
US Gov't10-Year/Moody BAA Corp. Spread	195 bps
USD/CAD Exchange Rate Spot	US $0.7609

* Period ending Sep 6, 2018

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practicality, the dominant extract what they can and the weak concede what they must.

The Bank of International Settlement (BIS) wrote a paper setting out what could be at stake if NAFTA was revoked. The study looked at two hypothetical scenarios. In the first, tariffs that were lowered under NAFTA revert to those under standard WTO rules and non-tariff trade barriers. This includes concessions such as preferential customs treatment and import quotas reverting to pre-NAFTA levels. In this event, GDP would decline by 0.22% in the U.S., 1.8% in Mexico and 2.2% in Canada. Total combined losses would be about US$ 99 billion a year. A full revocation would result in a real annual loss of US$37 billion in Canada, US$22 billion in Mexico and US$ 40 billion in the U.S.. In the second scenario, only tariffs revert to standard WTO levels. In this situation, the annual combined losses would amount to about $5 billion. Both cases are somewhat counterfactual for the distributional impact across industries would be an order of magnitude larger than the aggregate effects. In a world economy interconnected by global value chains (GVCs), domestic productivity depends on the availability of imported inputs. The above study clearly shows that President Trump is the big guy on the block. This is why, given his flamboyant and unrestrained personality, he feels that he can come out with outrageous tactics. He made a separate deal with a desperate Mexico and has manifested willingness to withdraw the U.S. from the WTO, to terminate NAFTA, and to place duties on Canadian-made autos if Canada does not acquiesce to his demands.

There are four sticking points that need to be resolved to ensure a Canadian position in the new NAFTA. The first point is the politically sensitive "supply management system" that supports dairy and poultry farmers. I have family in this business and they are aware that the system is archaic and should be undone. The problem is that many farmers are in debt thinking that the system is immune. The government will have to pay these farmers for relinquishing quotas. It should be noted that Canada has made some accommodations to the EU and TPP on this matter. Chrystia Freeland is probably not completely intransigent on this one. The second point is Chapter 19. It has to do with resolving disputes like countervailing or anti-dumping duties through a panel of supposedly impartial representatives. I have had difficulty understanding why this is raging on. History shows that sacrificing the deal over this is ludicrous, for the original dispute mechanism has rarely brought wins for Canada. Nevertheless, Trudeau believes these panels have worked reasonably well and have ensured fairness despite not much evidence on this one. It's my understanding that in the investor-state dispute settlement between Mexico and the U.S., certain measures in five sensitive industries were preserved. The third point is about digital trade and intellectual property. This area of negotiation includes the cultural exemption that is part of NAFTA. It has to do with Canadian sovereignty and identity. Essentially, Trudeau does not want Canadian TV networks to be swallowed up by U.S. communication giants. Canada does not seem to be against curbs on local data storage requirements or stronger patent protections. The concerns are with the French-speaking population and indigenous populations, fearing a U.S. cultural deluge. Hmmm. Strangely, the Quebec PMO seems more concerned with the faith of the dairy farmers. Lastly, Canada does not want to be identified as a national security threat and wants the U.S. to eliminate all tariffs on steel and aluminum and be permanently shielded.

It boils down to what Derek Burney, a former trade negotiator, wrote: "we are witnessing American divide and conquer, might-is-right tactics at their very worst. When we are confronted with schoolyard bully tactics, the choice is clear. Concede and hope that the behaviour will improve or resist in the hope that rational voices in Congress and business will constrain the president's worst impulses." Should the Canadian officials decide on the later option and give up the battle, the Minister of finance will have no choice but to reduce corporate taxes, accelerate depreciation allowances, stop protecting inefficient industries, enhance interprovincial trade, eliminate unnecessary regulations, bring under control abused welfare entitlements, construct oil pipelines, promote modern education of mathematics, computer science applied technology, creative design, engineering and coding and build state of the art infrastructures. These measures are a must if Canadians are to protect our remaining comparative advantages, keep our industry internationally competitive and assure our national independence. In my judgement, there is only one battle that Canada must win. That is the original dispute mechanism, rules should govern international trade rather than the changing whims of politicians.

William Galston of the WSJ wrote that "Trump Swims Against the Tide on Trade." According to a Chicago Council on Global Affairs survey

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released a few days ago, 82% of Americans believe trade is good for the economy, 85% think it's good for consumers and 67% think it's good for creating jobs in the U.S. As recently as 2016, the same survey found that only 59% of Americans thought trade was good for the economy. In two years, the percentage favouring trade rose 23 points. It would appear that Trump may have inadvertently sparked a significant broad-based shift toward pro-trade sentiment. Positive sentiment rose 16 points among Democrats, 25 points among independents and 31 points among Republicans.

Public favourable opinion on NAFTA during the past decade has soared from 42% to 63%. The surge has been especially strong among Democrats, whose support increased from 41% to 79%, while support among independents rose from 40% to 62%. Republicans have not budged--43% in 2008 and 43% in 2018. Yet, in the past year, as Mr. Trump ramped up his attack on NAFTA, public support for trade has risen by a broad based 10 points, 8 points among Democrats, 9 for the Republicans, and 11 for independents. Focusing his ire on Canada may be the wrong strategy. According to the Pew Research Center, 67% of Americans harbour warm feelings toward Canada, including 59% of Republicans. The bottom line is that Republicans are split on trade. Although Mr. Trump's working-class base supports his tough approach, the rest of the party does not. The WSJ goes on saying that after the November election, Republican officeholders will face a decision: stand up to Mr. Trump or concede and allow themselves to be branded the antitrade party. Pro-trade Republicans could join forces with Democrats, who have come to doubt the wisdom of giving so much discretion on trade to a president of either party. In reality, the problem is China. It would be smarter for the U.S. to join the Trans-Pacific Partnership, preserve NAFTA and make a deal with the E.U.. This would greatly strengthen Trump's hand in dealing with China. While the above sounds great, it would, nevertheless, be a strategic mistake for Canada to postpone any preparation. The U.S. could act on its own temptation to pull out from the existing global economic order. Canadians must get away from unsustainable fake growth and implement financial and economic reforms before it's too late.

Macro Issues and Money Management

In achieve alfa-performance and get beta protection, an investor needs to have a method. There are three important macro factors that should be looked at on an ongoing basis. These are: valuation-momentum metrics, the credit-business-monetary cycle and identifiable tail risks. Today, I will write about the credit-business-monetary cycle which is essentially about the bond market and the Fed. Over the next two weeks, I will present a dashboard of the "Valuation and Momentum" metrics that I also rely on to make investment decisions and list the "Known Tail Risks" that dictate the utilization of prudent hedges.

The Bond Market and the Fed

Investors make their bets on where the economy is going in the bond market. They know that ten-year bond yields are determined by past, current and prospective annual percentage changes in N-GDP. The records show that in the past ten years N-GDP increased, on average, at the annual rate of 3.48% and at 4.65% in the last four quarters. Given that the yield on ten-year bonds is presently 2.90%, my market-based model tells that bond investors believe that N-GDP will grow at the annual rate of about 3.75% to 4.00% over the coming years. How this calculated market-forecast is going to be divided between inflation and growth does not matter much. It may be an oversimplification, yet history is clear.

On the other hand, the Fed makes bets on where inflation and employment is going with monetary policy. The mandate of the Federal Reserve Bank is full employment which is an unemployment rate of 4.0% and price stability viewed as being 2.0%. This is not an oversimplification, it's a legislated fact. Presently, the rate of inflation is right on target at 2.0% and the unemployment rate is exactly where it should be at 3.9%.

Put simply, the factors that drive the Fed's monetary policy are different from those that influence the bond market. Nevertheless, the two propositions intertwine in ways that can directly affect the stock market. The problem is claiming that the job is simple. Investors need safe assumptions, reliable information, empirical evidence and valid theories, if they want to avoid terrible mistakes and make informed decisions. Acknowledging that understanding reality is complex, I use various non-identical asymmetric indicators to navigate the uncertainties of the future market outcomes. They are more like tools that historically have been very helpful in averting major trouble to develop sound investment programs and identify tipping points.

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Firstly, I want to know the lay of the land. Currently, the odds that the U.S. will be in a recession in the next six months are very low and 10% lower than where they were in the past three months which ranged from 12.0% to 15%. It should not be surprising since recessions normally occur when there are economic imbalances. There are no glaring macroeconomic imbalances forming on the horizon. Secondly, nowcasting dynamic models that access the present, estimate the very recent past and predict the near future are optimistic about Q/3. The Atlanta Fed, the New York Fed and the St. Louis Fed have estimates for real growth for the current quarter near 4.5%. Thirdly, despite trade wars and geopolitical disputes, financial stress keeps on decreasing. The St. Louis Financial Stress Index is not only low but has been on the decline since mid-March showing positive momentum. Fourthly, the core personal consumption expenditure deflator, the preferred inflation measure of the Fed, was up exactly 2.0% in July, right on target. The Cleveland Fed has an Inflation Nowcasting model, predicting that Core PCE will increase a bit below target at 1.89% in Q/3.

The bottom line is that the U.S. economy is in good shape and in a sweet spot. Thus, the question is whether the Fed is going to get in the way of this positive dynamic. At this point in time, it does not look as if this is the case. In this regard, I watch on a daily basis 1) four monetary-financial factors like credit spreads, yield curve, the differential between the neutral rate and the Federal funds rate, the money supply and real rates, 2) three commodity price ratios like Oil/Copper, Copper/Gold, and S&P 500 Index/Gold and 3) three economic indicators like the spread between the natural rate of unemployment and the actual unemployment rate, private sector savings (corporate savings plus household savings) and non-discretionary inflation. Obviously, these tools do not capture all the possibilities. But, suffice to say that if one believes economic history repeats itself, one can prudently depend on them to build scenarios.

Barring an unexpected shocking tail-event and accepting that valuations are not out of hand, the financial, monetary and economic conditions of the business cycle are telling us that we'll have more of the same and that the economy will just keep rolling. This bullish possibility is underplayed in the media given the strength of the data points. It should be noted that consumer confidence has soared to levels unseen since October 2000.

What's Going On: Canada

The Bank of Canada (BOC) decided to maintain its target for the overnight rate at 1.5%. However, the odds are above 80% that the BOC will hike its target rate to 1.75% in October. It should be noted that the monetary policy index that I closely monitor suggests that the BOC should raise rates. Monetary theories and empirical studies reveal that when a central bank does not tighten its monetary stance when it ought to, the currency normally falls. When one combines the above with the petty quarrel between Trudeau and Trump, one should not be surprised to observe the lingering softness of the Loonie. On Thursday morning, the Canadian dollar was settling for 75.80 US cents, four cents below its purchasing power parity rate. It should be noted that Canada's nominal trade deficit is vanishing quickly. Rising exports and falling imports have narrowed the trade deficit from $4.1billion in March/18 to $114 million in July/18. Should this Canada-U.S. trade dispute end, the Loonie would likely travel north toward its PPPR for the Canadian monetary authorities would have more liberty in conducting monetary policy.

Technical Perspectives of the Sevens Report (September 6, 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 2840 —2890.
2. Based on a proprietary model, the trend for Crude Oil is bullish with key resistance at $73.92 and key support at 65.20 — $68.75.
3. Based on another proprietary model, the trend for Gold is neutral with key resistance at $1243 and key support at $1159 — $1211.
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% — 2.90%

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