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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

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

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Palos Weekly Commentary

■ Mendel's Option Corner
By Robert Mendel

Cheese Please! Saputo is back.

If you recall several months ago when Saputo was trading at $41.50 I sold the July 38 puts which expired worthless giving us a 4.2% return. (Issue 18, May 13 2018)

Now the share price has fallen back again and there are several reasons for it; general soft conditions, competition, NAFTA concerns etc.., but it came back to the point where the risk/reward was worth it – just like last time.

So this is what I did. On Friday Sept 07, with the stock was at $38.15, I sold the Jan 38 puts for $2.00 for a potential 5.3% return in 134 days if it stays above $38 (14.4% annualized). Not that I follow technicals too much, but it does appear as if the stock is oversold and so I think a bounce is coming. If I am wrong I still have 5.3% downside protection before I lose any capital.

But if you wanted more downside protection, and who could blame anybody if they do, you could have sold a January 36 put for $1.35 for a 3.8% return in 134 days. That still would have equated to a 10.2% annual return.

It was successful once so join me in putting this play on. Call me.

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

Oh Canada, I Stand on Guard for Thee

What many Canadians do not understand is that the dispute-settlement mechanism was a gift that President Reagan gave to Brian Mulroney in October 1987. Unfortunately, President Trump does not like Justin Trudeau and resents being preached to about gender equality, ecological questions, feminism, native rights, human rights and right-to-work laws. These issues are important, but they do not have much to do with foreign trade and many of them do not fall under federal jurisdiction in either country. There will be no gift and no concessions this time around. Plus, the chances that Canada will be rescued by an indifferent Republican Congress is just too much to depend on. If there is any truth to the notion that elections are about the economy, it certainly is not a slam dunk that the Democrats will save the day in November. As I said last

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.57	-1.59%
Palos Equity Income Fund - RRSP	PAL 101	$6.33	-2.37%
Palos Merchant Fund L.P. (Mar 31, 2018)	PAL 500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL200	$8.61	-19.49%
S&P TSX Composite			0.78%
S&P 500			10.13%
S&P TSX Venture			-15.90%

Chart 2: Market Data*

	Value
US Government 10-Year	2.97%
Canadian Government 10-Year	2.33%
Crude Oil Spot	US $68.81
Gold Spot	US $1,201.50
US Gov't10-Year/Moody BAA Corp. Spread	190 bps
USD/CAD Exchange Rate Spot	US $0.7693

* Period ending Sep 13, 2018

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week, the powerful extract what they can and the weak concede what they must. To think that we are going to get out of this mess as a winner is ludicrous. The trick here is to salvage what he can. White House Economic Adviser Larry Kudlow, speaking on Fox Business, said Canada will have to make dairy concessions for a deal. If it is indeed about M-I-L-K, for god sake settle for the other side is far worse. Pay the dairy farmers for their quotas and press on. Canada paid for the Trans Mountain Pipelines. What's the big deal. I don't think that the US cares about giving some protection to Canada's economically insignificant communication industries and some sort of policing of whatever arrangement is concluded. I believe that a resolution is needed asap, before we lose out on everything. Canada needs this deal a lot more than the U.S does. There is no "win-win" deal in the offing. Few understand the logic of "game theory" where both do not need to win equally to make it a "win-win" deal. It seems to me that we are battling over a win-lose proposition that can only end-up in a "lose-lose" deal. Check last week's commentary. Put simply, a revocation of NAFTA means a .22% decline in the US GDP and 2.2% decline in the Canadian GDP.

Trump, speaking last Friday in North Dakota, said he believes Canada is ripping off the U.S. and repeated that, if a deal can't be reached, he'll apply a 20% tariff on cars. "In some countries, including Canada, a tax on cars would be the ruination of the country. That's how big it is. The ruination of the country," he said. "NAFTA has been the worst trade deal ever." When one hears and reads such outrageous statements, it's tempting for Canadians to get upset. The facts are that Trump is engaged in a fight to the end. He blames Reagan for the bad NAFTA trade; but not necessarily Canada. What has ticked-off Trump is that Canada got in his way when Trudeau tried to lever his position with the aid of the G-7 which never came. Canada does not have a current account surplus with the U.S. and, therefore, it should not be a serious matter for Americans. The E.U., Mexico, and Japan are the ones who are running large trade surpluses with the U.S.. Nevertheless, Trudeau took the wrong side thinking that he could get away with it and, in turn, showed strength to bargain harder. Neither the E.U. or Japan offered help. Trudeau should have known that success is much more likely with the U.S. than with the E.U. or Japan. The tactic backfired with Trump's rage. In response, Canada decide to take the gamble and negotiate a "skinny NAFTA" excluding Mexico. Reports reveal that Washington went for it, but Lighthizer rejected the idea and decided to divide and conquer. Because of that, the Mexicans, feeling that they were deceived by Canada, made a bilateral deal with U.S.. Now it's a lot about preparing the public for how the outcome will be perceived. How Canadians will judge the deal will be defined by how well the negotiators played defense. According to the Globe, recent polling says seven out of ten Canadians are trying to push back in limited ways by stopping to buy U.S. goods or decreasing travel to the U.S.

If Canada decides not to remove the protection of the dairy-supply-arrangement and not to allow more U.S. banking into the country because the PMO thinks that American threat is bunk, circumstances will force the government to adopt an all-out growth-oriented agenda. It may of course not happen for it was reported on Wednesday morning that Canada was ready to offer the U.S. limited access to the Canadian dairy market as a concession. This is despite the fact that the association of dairy farmers says that "they have hit a wall and that enough is enough." It's ridiculous to hold the entire country as hostage. Think about this, there are 11,000 dairy farmers and 120,000 auto workers. Don't think that reverting to the WTO and letting our dollar depreciate is a solution. These actions will not free Canada from dependence on the U.S.. As an aside, Canadian trade officials are working on a paper called "Strengthening and Modernizing the WTO." The paper proposes reforms to restore confidence in the multilateral trading system and discourage protectionist measures and countermeasures, seeking an alliance of like-minded countries. A meeting is scheduled to take place in Ottawa on October 24th and on the 25th. Great, but it will not solve the current impasse.

There is evidence that capital investment growth has slowed dramatically in the past few years. Given that foreign direct investors are more concerned than domestic investors and more informed than passive portfolio investors on business conditions, they serve as a valuable indicator of the attractiveness of a country as a location of business. In this regard, Canada is unattractive. FDI is doing poorly, especially in mining, energy and manufacturing sectors. According to the OECD, Canada is getting only 3.1% of FDI inflows to all developed countries. It used to be 6.2%. Obviously, Canada should carefully think about its development strategy. Canada does not have a lot of people. Its current population is about 37 million and the fertility rate is 1.6 children per woman. Even with Canada's liberal and selective immigration policy, at the

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current rate of population growth, it will only have 65.7 million people 50 years from now. Canadian population growth, albeit faster than in the U.S., is neither a short-term or long -term solution to bring about economic independence. What needs to be done? First, we must rid ourselves of old illusions that the U.S. will always be there for us. Second, we must realize that the US thinks that Canada is small, distant and unimportant. Third, we must believe that market efficiency and collective prosperity depends on us. The Governments must deal effectively with the caprices of some native leaders, the extravagant grandeur of our courts, relatively high corporate tax rates, and slow depreciation allowances It must find ways to attract flows of engineers and scientists to our tech hubs, eliminate business regulations, and promote interprovincial trade. These points are critically important if Canada wishes to increase productivity and become independent on the whims of our giant neighbour.

What's Going On: Canadian Stock Market

Canadian stocks are selling at an attractive discount to comparable US stocks. At the time of this writing, the TSX was selling at foreign exchange adjusted ratio of 425 times the S&P 500. That's a 20% discount from the trailing twelve month high of 525 times. Moreover, ten-year U.S. treasuries are yielding almost 75 bps more than Canadian counterparts, implying that Canadian earning yields should be that much less than what they are in the U.S.. The S&P 500 has forward earnings yield of 5.60%. Additionally, the undervalued Canadian dollar, being three cents below its PPPR, should bring about profit margin increases, higher export volumes and attract foreign portfolio investments especially if Morneau comes up with new investment incentives in October. Consequently, a resolution to the NAFTA dispute and new business incentives could change the sentiment surrounding the Canadian stock market possibly making it a good bet.

Tail Risk: Lack of Liquidity

The trick to put an end to our anxieties is to know what to worry about and how much one should worry about it. Liquidity is what we should be worried about and we need to what the inflation rate truly is. Liquidity runs out when provisions of money are low and/or when there is fear among money lenders that they will not get their money back from borrowers. Put differently, liquidity dries up when investors can't cash in a risky asset at market prices for reasonably low transactional costs. I can think of one thing that could cause a serious liquidity event. I'm aware that loans to students, to marginal oil producers and to indebted emerging countries may be too high, but none of these have reached critical levels that could trigger a liquidity event unless the Fed was foolish enough to push interest rates too fast and too high. Many emerging countries are experiencing an export surge, repayment schedules of student loans are being extended, and the market price of oil is above the marginal cost of production. Nevertheless, an aggressive policy mistake would bring about an inverted curve and positive real rates, overshooting the neutral rates. Fed is on record that it wants to delicately make the transaction from near-zero emergency interest rates of the post-crisis era into the lower end of range of what the Fed would call "normalization". For all intent and purposes, the Fed is on record for not letting interest rate cross what is considered the neutral rate. Officially, the U.S. neutral rate is 3.00% to 3.25%. Unofficially, the Laubach-Williams method calculates that the rate is 2.50% and so do I. The neutral rate measure limits how much the Fed will be able to hike interest rates before monetary policy becomes too restrictive. As you can see there is a range of opinions here.

In this connection, the best way to assess what the Fed is up too is to listen to Chairman Powell. He's the boss. He has a good knack at reducing noise and sticks with what is crucially important. He thinks that the Fed is dealing with now-defunct empirics, uncertain models and doubtful parameters. Put simply, the Fed is navigating with a defected compass.

It has to do with the so-called "Phillips curve" which is the empirical difference between inflation and unemployment. The relationship has not completely disappeared. Since the end of December 2015, the unemployment rate decreased from 5.5% to 3.9% today, eating away at the resource slack left in the economy, yet wage rates only rose from 2.0% to 2.9% for the comparable period. Incidentally, the Core PCE Index, the preferred inflation measure of the Fed, is right on target at 2.0%. Additionally, the unemployment rate should settle around the current level for the rate of expansion in total employment is about to slow down. At full employment, the inflation rate is still where the monetary authorities like to see it. The fact of the matter is that the so-called "Phillips curve" is broken. In the post-1995 timeframe, the "Phillips curve" as the standard to monitor the economy

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flattened and became less prominent than previously.

Accordingly, the Fed is far more likely to get information from market signals like the yield curve, real rates and market-based measures of inflation expectations and new straight-forward indicators like wage rates versus productivity rate (WR-PR). The federal funds rate is 1.875%. The market believes that the neutral rate is 2.50% and forward-thinking reserve banks peg it at 1.75%. If one was to average this out, one gets 2.00% to 2.25% or 2.125%. In this regard, we are betting on one last rate hike in September. Productivity causes miracles. I'm not of the school of thought that the Fed will follow its current path of gingerly rising interest rate to 3.00% for the decision-making process will become contentious, strangely turning former doves into hawks and new hawks into doves. Chairman Powell seems to be working toward a compromise by using a conventional risk-management strategy, allowing the goldilocks experience to continue until there is clear evidence that core inflation is really breaking to the upside of 2.0%. The new repeated formula may end-up in being dovish for Powell might just say: "Let's wait one more meeting". It's sensible for two reasons. First, simulations suggest that macroprudential measures like higher bank and capital and liquidity requirements and more stress tests are better to prevent liquidity events than the blunt effect of changes in the cost of money. Second, in the last 25 years, the Core PCE Index has very rarely crossed the 2.0% target, suggesting that inflation is so-well anchored that it has become an international standard of price stability. There is a long list of reasons for this long-lasting occurrence like the spreading of globalization, the diffusion of technology, and the underuse of employment. Moreover, positive developments like the pick-up in productivity as businesses invest more to address a tightening labour market and receive the efficiency benefits of technology advancements is a potential tailwind that isn't getting enough attention.

So rather than guess where the economy is going, the Fed and investors alike might be better off watching what is actually going on. In this respect, there are 17 indicators to monitor for their combined movements have historically been good reliable precursors of recessions. There has never been a bear market without a recession. Contrary to popular belief, bear markets start not before a recession starts but when a recession starts.

Below is my basic recession dashboard for the U.S. economy.

Is the yield curve inverted?	NO
Is the inflation trend down?	NEUTRAL
Is job creation down?	NO
Is credit performance down?	NO
Is the Mgf-ISM down?	NO
Is the Service-ISM down?	NO
Are Earnings down?	NO
Is the housing market down?	NO
Are real rates positive?	NO
Are light trucks sales down?	YES
Is car travel down?	NO
Is the avg. work week down?	NO
Are Job Claims rising?	NO
Are building permits down.	YES
Are new orders down.	NO
Is copper price declining.	YES
Are crude oil prices declining	NO

As of this week, only 2 out of 17 breakers tripped, many more indicators would have to trip to cause a problem. Moody's Analytics gives a low 10% chance that there could be a recession in the next six months, the Atlanta Fed is tracking a 3.8% annual growth rate for the third quarter of 2018 and the Cleveland Fed is projecting a 1.8% annual rate of increase in core inflation for Q/3. Investors should take note that price gains at both the consumer and business levels are trailing forecasts as gauges of underlying inflation cooled in August. What's the big rush to raise interest rates?

Technical Perspectives of the Sevens Report (September 13, 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 2818 —2892.

2. Based on a proprietary model, the trend for Crude Oil is bullish with key resistance at $72.27 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 3.07% and key support at 2.82% — 2.96%

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