

PALOS

September 20, 2018

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

FID on LNG

No concrete decisions have been made on LNG to date. However, there is some positive indication that LNG Canada is getting closer to reality. This \$40-billion Shell LNG terminal is crucial for Canada as it could create a pathway to Asia for Canadian gas. Here is what we are hearing, some of it may however be noise and should be taken with a grain of salt:

1. The mayor of Kitimat, Phil Germuth, continues to be optimistic and has been talking up the project in the media.
2. Petronas also bought a 25% stake in LNG Canada after scrapping its own project.
3. LNG Canada has aboriginal support.
4. There are rumors that Shell has a barge digging the inlet in Kitimat. Is this a sign that they are getting ready to receive construction materials via the inlet?

5. There are also rumors that Shell has rented the golf course hall. Are they getting ready for a celebration?

6. On September 18, 2018, Source Energy Services (SHLE) also announced that they signed a big sand contract with Shell. This will allow Shell to grow its Canadian operations. Why would Shell lock in supply?

All of the above points and rumors are indicating that LNG Canada is moving in the right direction. Usually where there is smoke, there is fire. I believe that the project will move forward. However, who will benefit from a positive FID? Most gas producers will react favorably but the move will probably be short lived as it will take years before the project gets completed. I'm more focused on companies that will immediately benefit from a positive FID such as Horizon North Logistics (TSX:HNL) and Mullen Group Ltd (TSX:MTL). I prefer HNL over MTL, and own HNL in the Palos Funds. However, I do think both companies would benefit.

HNL provides a workforce accommodation camp. We view HNL as being very well positioned to be

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	\$9.68	-0.42%
Palos Equity Income Fund - RRSP	PAL 101	\$6.39	-1.44%
Palos Merchant Fund L.P. (Mar 31, 2018)	PAL 500	\$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL200	\$8.84	-17.38%
S&P TSX Composite			2.12%
S&P 500			11.16%
S&P TSX Venture			-15.20%

Chart 2: Market Data*

	Value
US Government 10-Year	3.06%
Canadian Government 10-Year	2.42%
Crude Oil Spot	US \$70.80
Gold Spot	US \$1,207.10
US Gov't10-Year/Moody BAA Corp. Spread	190 bps
USD/CAD Exchange Rate Spot	US \$0.7749

* Period ending Sep 20, 2018

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the main provider of accommodation camps. HNL has 57-acres of land strategically positioned within the district of Kitimat, with most of the land fully serviced. Some of the land is already zoned and permitted for a 1,000 bed camp and the company is working to get more. If we get a positive FID, HNL's EBITDA could double very quickly, I think this could bring \$70 mil of recurring EBITDA. At \$2.60 a share, HNL is pricing zero LNG, and I believe the odds are in its favor.

■ Mendel's Option Corner

By Robert Mendel

Boy, do I long for the days of non-volatile stocks like Tesla. I remember the days of last month where Elon Musk's tweets would move the stock 15% in a day. After Tilray, we need those boring days again. Not even during the dotcom bubble have we seen a stock like Tilray move like it has in the last few days.

I came across an article last week about how it was next to impossible to short Tilray, a marijuana company which went public in July at \$17 per share and was currently trading at \$110 per share. (That's a great 10 year move and here it happened in a few months) The article noted that even if you could find a borrow to short the stock the fee the dealer would charge you was close to 100%, making it extremely expensive. And rules are you need to first secure a borrow first before shorting a stock so you really had to pay up if you wanted to do it. Unless of course you traded Tilray options. We can use options to short the stock and circumvent those insanely big borrow fee rates and perhaps accomplish the same thing.

A few days after the article the stock was higher, trading at \$125. And a few days after that it was even higher at \$153 after the company announced they will export product into the USA for a medical trial. So I smiled thinking this huge runup was massive human irrational behavior at its best. Now this was the time to strike and this is what I did.

Right before the close on Tuesday September 18, I sold 5 September 21 180 calls for \$5.00. Even though I thought it was overpriced at \$153 I didn't want to get in the way of the huge momentum pushing it higher so I wanted the \$27 extra room even though it was only a 3 day play. (\$180-153) So I could be wrong by \$27 and still make money. And my break-even was \$184.70 (\$180+4.70) Then an interview by the CEO and the fun really

began. The only word that was appropriate was OOPS.

Wednesday morning the stock opened at \$235 and shot up to \$300 before falling back to \$175 only to settle at \$214. The stock was so volatile it was halted 4 times. (the exchange has an uptick/downtick rule to halt stocks for a few minutes if it moves over 10%) And today, the stock opened flat but quickly shot back up to \$244. At its highest point yesterday the option I sold for \$5 was worth \$120. Again, what's that word?, oh yeah...OOPS. But the good thing is I was short an option, and with it brings different choices. My plan was to stick to my guns, roll over for one week and collect more money. But that may have to wait because as I write this the stock is back under \$180 (my strike, making the actual option worthless) and trading at \$175.

I think I need a boring stock like Tesla!

Let's see how it unfolds with one day to go and I will keep you posted.

■ What is New on the Macro Level?

By Hubert Marleau

The Growing Global Economy

The global economy has not been nearly as bleak as the abundance of pessimists like to paint. On the contrary, since the end of the financial crisis, the world economy has done comparatively well. According to the International Monetary Fund (IMF), the rate of real growth averaged 3.7% for the world GDP in the 2000-2010 period. By comparison, the average annual rate of real growth for the 2010-2018 period has been 3.5%. It might be slightly less than the previous decade, but above the 3.3% world growth that was registered in the 1980's and 1990s. In many ways, the tunesmiths that compose bleak pictures have also had a few other important things wrong.

First, the financial imbalance between the U.S. and China has been corrected for the better. In 2008, the U.S. current account deficit was about 5.0% of N-GDP compared to 9% surplus for China. Remarkably, significant progress has been made on these two fronts. In the first half of 2018, China's current account surplus as a percentage of N-GDP was only 1.0% while the U.S. registered a deficit of 2.25%. This is particularly encouraging because many have partially attributed the 2007-2008 financial crisis to these imbalances. Most economists believe that a current-account deficit-to-N-GDP of 3% is sustainable and manageable.

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Second, the distinction between income and wealth inequality is often blurred by commentators the interpretation subject but not always well understood. Records show that while income inequality increased in the past ten years, (much less than wealth inequality). The rapid rise in urban housing prices played the biggest role, according to Chatham House. Unlike the 2000-2007 period when the housing bubble took place, today's increase in real estate price is not part of the recycling of the national savings of countries with current-account surpluses. The increase in real estate prices is concentrated in major international cities like NYC, London, Paris and Toronto — the buyers being multi-millionaires. It should be noted that international real estate prices are breaking down and should help to arrest the rise in wealth inequality. It's not that we don't have international issues that should not be left unattended, but the global saving imbalance that caused the last crisis will likely be the one that could cause another crisis.

The Case for a U.S. Productivity Surge

Productivity is a recurring theme of mine. If the U.S. economy is to grow at the annual rate of 4.0% in Q/3 as the Atlanta Fed estimates, one could deduce that in the year ending September 2018, productivity will be up 1,6%. I believe that this all-important economic factor will continue to grow as a result of the rising diffusion of science. Widening and deepening globalization, increased digitalization of data and information, and growing numbers of scientists and techies are factors that are bringing about an innovation-led economic expansion. A growing body of literature is highlighting that a host of advanced technologies is spreading all over the place. As input and labour costs rise and excess capacity is being worked off, businesses are substituting old ways for new ones. The numbers show that business investment has turned. Moreover, the withdrawal of ultra-accommodative interest rates should encourage a more efficient allocation of capital. Interestingly, the economy is growing considerably faster than the money supply for private savings as both the business and household levels are claiming an increasing portion of the national income, suggesting that the bulk of the current expansion is taking place with limited use of credit. The negatives that prevented productivity to take hold in the past 20 years are being replaced with positives, boosting creative destruction.

U.S. Monetary Policy

The Federal Reserve Bank will increase its policy rates to 2.125% on September 26th because the inflation rate is on target at 2.0% and the economy is operating at full employment. While this forthcoming hike is fully expected by Fed watchers and financial markets alike, it should not be assumed that the shrinking of the Fed's balance sheet and future rate increases are on autopilot. The probability of a pause in the tightening cycle has risen with the arrival of Powell's tenure. Commodity prices have weakened, producing downward pressure on both producer and consumer prices and keeping inflation expectations near the 2% Fed target. The Cleveland Fed's Nowinflationcasting model lowered the estimated core inflation for Q/3 to an annual rate of 1.6%. It should also be noted that several daily market ratios like Copper/Gold, Gold/Palladium, Oil/Copper and S&P 500/Gold are strongly suggesting that the current expansion path of the economy is driven more by productivity and employment than inflation. Global producer prices are in the process of peaking and U.S. consumer prices are about to roll over, explaining the tenacity of inflation expectation. These yellow flags could possibly change the Fed's rhetoric. Powell may surprise Fed watchers and Fed models by introducing a new put, capping the policy rate with only two more hikes and waiting for signs of inflation pressures before pressing on. The need to have a go-slow strategy becomes even clearer when one realizes that financial turbulence abroad represents a big risk to the Fed's official plans. Richard Clarica, the new vice chairman of the Fed has written about how international linkages can make it hard for the Fed to raise rates without triggering volatility in other economies, especially emerging ones.

The U.S. China Trade Dispute

With Trump's announcement of a 10% tariff on \$200 billion worth of Chinese goods and China's response of 5% to 10% retaliatory tariffs on \$60 billion in U.S. goods, trade tensions are growing, perhaps becoming personal but surely political. Barring a deal before year end, U.S. tariffs will rise to 25% and tariffs on an additional \$267 billion worth of Chinese imports will be imposed. It may surprise some novices that the markets have shrugged off these punitive measures and synchronous retaliations. The presumable objective may be to defend economic interests, yet they are hurting the global free trade order. There

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are several reasons why the markets have not negatively reacted.

The tit-for-tat measures were widely anticipated and therefore baked into the market prices.

There is a belief that in the end, the trade disputes will be satisfactory resolved as the staggered increases in tariffs suggest that there is room for negotiations.

The tariff on the U.S. economy is fractional--Chinese tariffs will impact only 12% of U.S. imports, it means that on average tariffs increase prices 1.6% across all imports. This is tiny compared to the 1930s when they were 22%.

Seasoned American and International investors are aware the problem with China is not about the bilateral trade deficits but about China's unfair policies and practices related to technology and intellectual properties. The U.S. trade deficit is about comparative manufacturing advantages overseas which are creating cheap consumer prices for low end products thus providing global capital flows which are indirectly creating extra and easy credit for consumers.

Based on a 10% tariff on \$200 billion worth of Chinese imports and the 5% to 10% synchronous retaliation on \$60 billion worth of American goods by China, Tom Essay of the Sevens Report reported that on a worst-case basis the base line 2019 full-year S&P 500 EPS of \$179 would be cut to \$174 a share. That puts the market at a multiple of 16.20X. This scenario would not, by itself bring about a bear market because it would still be fairly price. Should stock prices correct by 10%, the earning yield would shoot up to 6.90% making the market attractive vis-a-vis 3.00% bond yields. Because earnings on a year over year basis are still rising fast and the fundamentals of the economy are holding up well, a dissipation of trade tension would greatly aid sentiment which would be very bullish.

What's Going On: Canada

This Thursday morning, the Canadian dollar was trading for 77.55 US cents, near its Purchasing Power Parity Rate (PPPR) of 80 US cents. The Loonie is the only currency that is down marginally against the Greenback among all major currencies, since April 1, 2018. As a matter of fact, most currencies are deeply lower vis-a-vis the U.S. dollar, ranging from the Brazilian Real to the Swiss Franc including the Euro, Yen, Pound,

Yuan and the Australian Dollar for the period under review. Interestingly, since April 1, 2018, interest rate differentials have widened in favour of the U.S., and oil prices are up very little, American economic growth is superior to that of Canada and inflation rates are similar. Maybe, the market is signaling that NAFTA negotiations are not as stuck in the mud as pundits think. Canadian officials might feel the pressure to get this done now or very soon.

Technical Perspectives of the Sevens Report (September 20, 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 —2912.
2. Based on a proprietary model, the trend for Crude Oil is bullish with key resistance at \$72.47 and key support at 65.20 — \$71.42.
3. Based on another proprietary model, the trend for Gold is neutral with key resistance at \$1243 and key support at \$1159 — \$1208.
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 2.86% — 3.08%

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