Issue 39

PALOS

September 27, 2018

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

More Positive News on LNG Canada

The Federal government has agreed to remove tariffs on imported steel modules for the LNG Canada project. This is significant as it takes away a lot of the uncertainty on the project. LNG Canada has argued that there are no Canadian suppliers of steel modules as tall as 10 storeys. The removal of the tariff will also reduce the cost of the project by at least $1 billion. This action, by the federal Government, is another decision in the right direction and further increases the probability of a positive FID. I continue to believe that we will have a final and positive decision by the end of the year.

Last week I spoke about Horizon North Logistics (TSX: HNL) and how it stands to benefit from a positive FID. Another name that we hold in the funds that would benefit is Mullen Group Ltd (TSX: MTL). They specialize in the trucking of unconventional truckloads. As you can imagine, there will be tremendous amounts of large, bulky and prefabricated equipment to be delivered to the LNG construction site. The best positioned company to provide this service in Western Canada is MTL. However, even without LNG, the company is performing well. MTL reported a strong second quarter, which exceeded the street's forecasts on both revenue and margin. We see LNG as a free option for MTL that can have a significant positive impact on its business.

■ Mendel's Option Corner

By Robert Mendel

Hey what's a little weed killer in granola bars at the end of the day to stop me from making an investment? Nothing! Someone has got to defend the Pillsbury Cookie Dough man and Yoplait yogurt.

General Mills just settled a suit brought by several consumer groups that alleged its Nature Valley granola bars were deceptively labeled "100 percent natural" even though they had traces of glyphosate residue – the weed killer.

General Mills, which was over $60 at the beginning of the year, had been trending down since and hit a 52-week low of $41 on May 3. I thought now was the time and there were two ways to play it; depending on whether or not you

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.71	-0.07%
Palos Equity Income Fund - RRSP	PAL 101	$6.40	-1.25%
Palos Merchant Fund L.P. (Mar 31, 2018)	PAL 500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL200	$8.99	-16.00%
S&P TSX Composite			1.85%
S&P 500			10.23%
S&P TSX Venture			-16.75%

Chart 2: Market Data*

	Value
US Government 10-Year	3.05%
Canadian Government 10-Year	2.42%
Crude Oil Spot	US $71.57
Gold Spot	US $1,187.00
US Gov't10-Year/Moody BAA Corp. Spread	183 bps
USD/CAD Exchange Rate Spot	US $0.7681

* Period ending Sep 26, 2018

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had cash. I played it both ways. The first way is to buy the stock and sell a covered call and the second is to sell a put.

This is what I did. On Wednesday September 26, I bought the stock at $43.87 and sold the November 16 $45 calls at $0.75 cents for a cost of $43.12. If the stock stays here, I will make 1.7% in 51 days or a 12.2% annual return excluding the dividend. If we factor that in - it goes x-div on October 9 and will pay $0.49 cents - the return goes to 2.9% for 51 days or 20.8% annually. And if I let the stock get taken away from me (has to be over $45), then the return is 4.4% for 51 days and 31.5% annualized, excluding the dividend. Now for the second way, I sold the January $42.50 put for $1.90. This equates to a 4.5% return in 51 days or 32.2% return with a 3.1% downside protection to still maximize my profit. Keep in mind that no dividends are at play since it's an option.

Either way, bring on the weed killer and after a wild week of Tilray I needed a little break.

Speaking of Tilray, let me update you on how it turned out. So last Thursday, after submitting your favorite reading article of the week (mine), I rolled out the option one week to September 28 to collect more money. I wanted to do that to have one more opportunity to collect money before what I thought would be a downturn. So specifically, that afternoon I bought back the 5 September 21 $180 calls for $14 and sold the September 28 $180 calls for $26 for a $12 credit, bringing my total credit to $17. The next day, the stock fell fast – much like it had risen - and when the stock touched $131, I covered the call for $5.50 leaving me with a net profit of $11.50 ($17-5.50) All ends well.

Now I will go buy some Cheerios – yes they sell that too.

Until next week.

■ What is New on the Macro Level?

By Hubert Marleau

What Is Going On in the U.S.

As widely expected, the Federal Reserve decided to raise its benchmark rate 25 bps to a range of 25 to 2.25%---the third increase this year and the eight since December 2015. While another hike is anticipated in December, the language was the most important takeaway in the FOMC's press release. We know that the Fed isn't on a preset course and that the future monetary stance will be dictated by incoming data. However, the Fed faces two competing forces. First, the economy is operating at full employment as the unemployment rate is below the Fed's long-run forecast. Second, the rate of inflation is right on target and appears in check. As a matter of fact, the FOMC has been facing this dilemma for several years. What has saved the day from concerns over inflation, has been steady productivity gains since the end of 2015. Put simply, productivity is the reason why the economy is in a sweet spot. As the Fed feels its way towards the right economic equilibrium level of not being too hot or too cold, it does not look as though the economy is at risk of falling into a recession anytime soon; even though some cyclical sectors like housing construction, consumer spending on durable goods and business capital formation have slightly weakened. However, U.S. consumer sentiment and business confidence are at an all-time high; boding well for economic activity. In other words, the decision to raise rates is not likely to get in the way of continued healthy growth.

My dashboard of indicators, that have historically been good precursors of business activity, are generally moving forward, keeping the economy strong. For example, the Atlanta Fed's GDPNow model is forecasting an annual rate of growth of 4.4% for Q3 and Moody's Analytics is predicting 3.9%. Meanwhile, the Cleveland Fed's Inflation NowCasting model is presently calculating that the annual pace of core inflation for Q3 will be 1.67%. The updated Summary of Economic Projections showed the Fed expects stronger GDP growth this year and next. Consequently, the Fed must feel confident to describe the new rate policy as no longer accommodative, suggesting that there is no need to press the pedal to the metal.

There are other views as to why the Fed chose to drop the notion of accommodation. Some people think it's because Chairman Powell wants to move away from providing overly precise estimates of where the neutral setting stands or that it's no longer constructive. I disagree on both counts. I posit that the Fed thinks that the economy is still in the middle of the cycle, as does Moody Analytics, and, in turn, does not want the market to put too much emphasis on only one moving variable. The point is that the monetary authorities probably want to make as sure as possible that they can keep supply and demand relatively well balanced. In this connection, they do not wish the market to think that the Fed would intentionally invert the yield curve, raise short-term interest rates way above inflation, push long

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term rates beyond the pace of N-GDP and allow the Federal Funds Rates to increase above the financially calculated neutral rate of 2.875% (five-year treasury yield) and/or above the economically calculated neutral rate of 3.125% (N-GDP less Productivity).

In my judgement, the best way for the Fed to prevent the economy from overheating and keep the economic pace going, is to avoid too much of a restrictive monetary posture. The bottom line is for the Fed to prevent the Federal funds rates from going above 3.00% and, at the same time, ensure that quantitative tightening sells enough bonds to prevent an inversion of the yield curve. On Thursday, the neutral rate was 2.95% and the spread between the ten-year bond yield (3.06%) and the three-month T-Bill rate (2.19%) was 87 bps. Meanwhile, ten-year treasury yields are about 25 bps lower than they ought to be, suggesting that the economic expansion is heading towards a normal nominal annual pace of 4.50% —a sweet spot for the Fed.

New Technical Perspectives as of September 27, 2018—Sevens Report

1. Based on the Dow Theory, the trend for the S&P 500 is bullish, with key resistance at $2984 and key support at $2840. Last price: $2914
2. Based on a proprietary model, the trend for Crude Oil is bullish, with key resistance at $73.87 and key support at $67.53. Last price: $72.35
3. Based on another proprietary model, the trend for Gold is neutral, with key resistance at $1243 and key support at $1159. Last price: $1199
4. Based on a proprietary model, the trend for 10-year treasury yield is bullish, with key resistance at 3.13%. Last yield: 3.06%
5. Based on a Palos Currency Model, the trend for the Canadian dollar is negative with resistance at 0.80USD and key support at 0.75USD. Last price: 0.7653USD. A surprise NAFTA deal could break the trend to the upside. Divergent monetary stance is a negative but would change with a NAFTA deal. The bullish oil trend is holding the Loonie higher than where it should be.

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