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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Shell Gives Green Light to Invest in LNG Canada

I'm very pleased that Shell has given the green light on LNG Canada. I now see this initial positive FID as a first of several LNG projects. It is opening the door for Kitimat LNG, WCC LNG, and LNG Canada Phase 2.

However, many analysts and investors seem to be focused on the E&Ps, but we see the LNG project as a long term positive for the gas producers. LNG Canada will not be built in one day, it will take years. We see the knee-jerk reaction in the gas producers as a selling opportunity to trim.

I prefer investing in companies that will get contracts in the next few months. Such as Horizon North Logistics Inc (TSX: HNL), Enerflex Ltd (TSX: EFX), and Mullen Group Limited (TSX: MTL).

There is, however, another sector that will benefit in the long term but did not react at all. We see the pipelines & energy infrastructure as a long-term beneficiary of LNG Canada. For example, Pembina pipeline Corp (TSX: PPL) is well positioned to directly benefit from the positive FID via its Veresen midstream assets. We also see Keyera Corp (TSX: KEY) benefitting as we are expecting an uptick in drilling. KEY should indirectly benefit as volumes ramp up in the Motney. I'm of the opinion that sentiment on energy infrastructure will change as the LNG project moves forward.

■ Mendel's Option Corner

By Robert Mendel

Constellation Brands was meandering (I had to look up the word) around the $205 range when they announced an investment in the only thing in Canada anybody really cares about these days, cannabis. Constellation, the owner of Corona beer among others including wines and spirits is the world's largest premium wine producer and needed to branch out to address slowing sales – an issue other beverage companies are also facing.

The stock, which traded over $236.50 by end of April had since been trending down to the $205 range, a correction of over 12.5%. And after the announcement of the investment into Canopy

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.55	0.32%
Palos Equity Income Fund - RRSP	PAL 101	$6.31	-1.02%
Palos Merchant Fund L.P. (Mar 31, 2018)	PAL 500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL200	$9.04	-15.55%
S&P TSX Composite (Total Return with dividends reinvested)			1.41%
S&P 500 (Total Return with dividends reinvested)			11.00%
S&P TSX Venture (Total Return with dividends reinvested)			-16.70%

Chart 2: Market Data*

	Value
US Government 10-Year	3.18%
Canadian Government 10-Year	2.55%
Crude Oil Spot	US $76.41
Gold Spot	US $1,199.00
US Gov't10-Year/Moody BAA Corp. Spread	183 bps
USD/CAD Exchange Rate Spot	US $0.7772

* Period ending Oct 3, 2018. Data extracted from Bloomberg.

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Growth the share price subsequently fell further to under $199 on August 17.

But it got me curious, so I dug in a little more and came to the conclusion that in the short run at least this was an undervalued play. But stocks can stay undervalued for many months if not longer, so I needed a catalyst, so I hid behind my tree and waited and waited. And then it came, like a gift from heaven. On Oct 1st the company was downgraded by a reputable US firm to a street low target price of $165 in advance of the earnings release on October 4th because of a weakening outlook. Now I love these analysts, and why shouldn't I? I usually do the opposite and most of the time come out on top. My thought was that most of the news was already factored into the share price and the outlook wouldn't be too bad.

So I jumped in and did this. In the afternoon of October 3rd with the stock at $209 I sold an October 5th $202.50 put for $1.60. This equated to only a .8% return, but it was for only 2 days, so not too bad. The company reported better than expected earnings (oops, Mr. Analyst) and the stock opened at $224. (As I write this the stock is trading at $221). So assuming it stays above $202.50 by tomorrow I keep my premium. I think I am ok. Yes, I could have sold a higher strike price, or even gone long the stock and would have made more money but wanted a little more downside protection just in case the analyst was right. But a hit and run play is never bad. And I now move on.

Until next time.

■ What is New on the Macro Level?

By Hubert Marleau

What Is Going On in the U.S.

This Time It's All About Sustainable Growth and Stable Inflation

The U.S. economy is in a sweet spot. The economy is operating at full employment and profitably under price stability. For as long as inflation remains contained and stable, there will be no recession. It explains why the Fed decided last Wednesday to play a "wait and see" game rather than painting itself into a corner with strict rules that may upset the current even keel. In this regard, Fed will try to ingeniously engineer a soft landing. It has a very good chance of success for it is expected that Powell will prudently prescribe the appropriate medicine.

Firstly, the economic expansion is about to settle around a sustainable 2.50% growth factor. There are headwinds approaching like the eventual tailing-off in fiscal stimulus, the potential disruptive effects of the trade disputes with China and the reduction in the pool of available workers. However, the combination of productivity gains, sky-high consumer sentiment and elevated business confidence should keep the cycle positive. About a third of companies surveyed by Korn Perry are directing their tax-cut savings toward worker training programs and another third to business investments to enhance productivity---about a third is going to dividends and share buy-backs. Incidentally, durable goods orders, which is a good proxy for business investment, are rising robustly. The gauge jumped 4.5%, or $11 billion, to $259.60 in August from the previous month.

According to an August 28-September 17 poll of 51 forecasters issued by the National Association for Business Economists, about two-thirds of them see a recession in late 2020 or 2021 or later. Interestingly, 50 % of them said that the biggest downside recession risk was trade policy. The economic terrain has changed since, for we now have a U.S.-Mexico-Canada Agreement and the U.S. has started serious trade talks with the European Union and Japan. According to Moody's Analytics, there is no recession in sight for there is only a 10% chance that a recession could occur in the next 12 months. In our judgement, peak performance was achieved in Q/2 when GDP grew at the annual rate of 4.2%. I've knocked down my Q/3 growth to 3.75% and Q/4 to 3.25%. My dashboard of 20 indicators is pointing at 2.75% for 2019 and 2.5% for 2020 and 2021, suggesting that the bulk of the expected growth will come from continued recovery in productivity. It should be noted that in the last four quarters, demand has exceeded supply by about $450 billion. When final demand is running well ahead of supply, it usually brings about lower inventories and larger trade deficits. The only way to catch-up is through better supply management. There is little wonder why ISM readings show that businesses are working on improving transportation, reducing labour input, curing delivery issues and servicing more clients for new orders for goods and services are comfortably robust. The U.S. economy is motoring ahead in logistics. Orders for big Class 8 trucks keeping hitting records.

Turning to inflation, inflationary pressures are modest. The fed's preferred measure of inflation, the Core PCE Price Index rose 0.1% in August, PALOS

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creating a y/y increased of 2.0%--- right on target so far as the Fed is concerned. There is no reason that something will break to the upside. As a matter of fact, monthly core PCE prints moderated over the summer, averaging just 1.3% on an annualized basis from June through August. Here again the force of productivity is showing its hand. Average hourly earnings were up 2.9% year-over-year in August. It may seem large by recent standards, but not really. For the period under consideration, productivity increased 1.5%, possibly more. It means that cost push pressure was only 1.4%.

Yesterday, Fed chairman Powell argued that rising wages do not suggest that the job market is overheating, citing the experience of the 1990s when an acceleration of wage growth did not trigger much inflation. The 1990s experienced good productivity gains. The Cleveland Fed's Inflation NowCasting model predicts that core inflation only rose 1.75% in Q/3. I'm sure that Chairman Powell is aware of this. In this connection, I interpret the removal of "accommodative" from the Fed's statement as a sign that the central bank is nearing its interest rate normalization process and that future interest-rate hikes will be only of cyclical nature. As for the latest round of tariffs on Chinese goods, the impact on total consumer prices will be modestly noticeable. A quick back-of-the-envelope calculation shows that 10% tariffs on $200 billion in imports implies an extra cost of $20 billion, or 0.1% on N-GDP----all of which would end up in adding the 0.1% to the y/y growth in measures of core consumer prices. All told, we expect core inflation to keep running at the annual rate of 2.0%.

Put simply, investors should cautiously bank on more of the same for many more quarters.

New Technical Perspectives as of October 4, 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 —2919 on Thursday morning.
2) Based on a proprietary model, the trend for Crude Oil is bullish with key resistance at $75.27 and key support at $68.93 —$76.26 on Thursday morning, above the highest key resistance of $75.27.
3) Based on another proprietary model, the trend for Gold is neutral with key resistance at $1230 and key support at $1159 — $1203 on Thursday morning.
4) Based on a proprietary model, the trend for 10-year treasury yield is bullish with key resistance at 3.13% and key support at 2.04%---3.16% on Thursday morning, above the highest key resistance of 3.13%.
5) Based on a Palos Currency Model, the trend for the Canadian dollar turned neutral with resistance at 80.00 us cents and key support at 75.00 us cents---77.81 us cents on Thursday morning. The September 30 Nafta deal broked the trend to the upside. We can now expect the Canadian monetary stance to closely imitate that of the Fed until the end of the year. Accordingly, the bullish oil trend could keep the Loonie strong enough to reach its PPPR of 80 us cents, but not beyond that data point. Why? It is unnatural for differentials in interest rates between Canada and the U.S. to favour our southern neighbor by at least 50 bps. Canada has a large current account deficit that accounts for 2.75% of N-GDP and a very uncompetitive corporate tax rate that is about 10 percentage points higher than in the U.S.—the top marginal rate is 36% in Canada versus 26% in the U.S.A.. It should be noted that there a good chance that Finance Minister Morneau may fix this disadvantageous tax rate and introduce productivity measures this fall or in the next federal budget. He did acknowledge the problem last month. How he will address the deficiencies will partially determine the faith of the Canadian economy and that of the Loonie. Admittingly, the announced LNG project in Kitimat is a good start. But, Canada needs pipelines to unblock our resources, incentives to promote productivity, less regulations and freer trade within Canada and abroad. We have 16 years in front of us to diversify our economy beyond the U.S.. Canadians must find a way to redirect private savings away from residential construction to business capital formation. I trust that Canadians are smart enough to do what is right.

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