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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

The Auto Part Companies Are Taking It On The Chin

Auto part makers have been seriously suffering these past few weeks. However, the sector did enjoy a short-lived uptick when Canada and the US announced a preliminary trade agreement. After the NAFTA announcement, the auto part companies traded higher. However, a few days after they drifted right back down. See the Martinrea International Inc (TSX: MRE) chart below to have a better understanding of the volatility.

The price action in the sector lead us to do some work on the auto part companies. We are of the view that more weakness could be in store, but the current valuation is just too compelling to ignore. MRE is now trading below its pre-NAFTA agreement multiple, which was a reason for its underperformance and compressed multiple. However, this is not only an MRE phenomenon but an industry one.

Magna International Inc (TSX: MG), and Linamar Corporation (TSX: LNR) are also trading well below their pre-NAFTA agreement multiples. The sector is trading around 4.5x 2019E EV/EBITDA

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns)*	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$9.14	-4.00%
Palos Equity Income Fund - RRSP	PAL101	$6.07	-4.85%
Palos Merchant Fund L.P. (Mar 31, 2018)[1]	PAL500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL210	$8.70	-19.37%
S&P TSX Composite (Total Return with dividends reinvested)			-2.03%
S&P 500 (Total Return with dividends reinvested)			5.76%
S&P TSX Venture (Total Return with dividends reinvested)			-18.44%

Chart 2: Market Data[2]	Value
US Government 10-Year	3.16%
Canadian Government 10-Year	2.54%
Crude Oil Spot	US $73.17
Gold Spot	US $1,220.00
US Gov't10-Year/Moody BAA Corp. Spread	184 bps
USD/CAD Exchange Rate Spot	US $0.7652

[1] Period ending Oct 10, 2018. Data extracted from Bloomberg

[2] Fund is priced annually

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which is at the historical low. The fund's favorite name is MG because the company has shown growth in Sales, EPS and Cash Flow. It's also making a big push in the electric vehicle segment. MG trades at 4.3x 2019E EV/EBITDA and usually trades at a premium to its peers.

I view MG as a great opportunity at these levels, and it is now one of the holdings of the funds. I also like MRE, but mostly because it's trading at 3.3x 2019E EV/EBITDA. MRE is inexpensive, and management has been doing a good job in increasing margin and turning the company into a cash flow machine. However, MRE still has a lot of work to get its margins closer to its peers. Every quarter MRE has slowly improved its margin. Because MRE is just too cheap to ignore down here, the funds have taken a long position in the name.

■ What is New on the Macro Level?

By Hubert Marleau

What Is Going On in the U.S.: Bonds Are Always in the Driver's Seat.

The Terminal Federal Funds Rate Is Close.

As I write this, ten-year treasury yield sits at 3.25%, the spread between long and short yields is 100 bps, and the neutral rate (3.05%) is 90 bps above the Fed's policy rate. Meanwhile, real rates are still negative. A lot happened in the last few weeks and it's about proof that economic growth is strong and inflationary expectations are rising. Investors should take notice that a steady erosion of inflation is, in reality, a far bigger danger to bond yields than rising short-term interest rates. Unless we see inflation pick up materially, it's hard to believe that a major bond bear market is in our midst.

The market is on the fence when it comes to interpreting the steady stream of superlative data. In my judgement, the market is reacting to official bullish comments crying wolf. The bond market is catching up with the reality of the economy. Let's assume that the U.S. economy will end up in 2019, as we forecast in the commentary of last week, growing in a sustained manner at 2.50% with a 2.20% annual rate of inflation, the ten-year treasury yield would settle around 3.50%. And, if one believes that the Fed policy and/or productivity gains will keep inflation at bay near 2.00%, ten-year yields are now where they should be---near 3.25%. Interestingly, Blackrock thinks that the latest runup in the 10-year treasury yield will not go on for much longer and better still, it offered a well-documented opinion that bond yields are coming to the end of their seven-year rise.

Some say that the marker for worry is 3.75%. These bond numbers are not high or outlandish, when one considers that economic data is topping out and signaling good but reduced rates of growth. Moreover, the recent breakout in long-term yields removes the negative effect of an imminent yield curve inversion. It's certainly a preferred place for the market to be in, given that the annual change in the PCE Inflation Index is near 2.00%. As a matter of fact, there was no clear catalyst for the interest rate surge other than the catch-up thesis.

What is particularly interesting is that while the level of volatility jumped, it was comparatively low considering the accompanied rise in bond yields. This suggests that the market believes long-term yields will soon stabilize. It makes sense because industrial prices are weak, and the dollar is strong. Contrary to popular belief, the rise in oil prices functions much more as tax than anything else. It may be counterintuitive, but history is clear that increases in oil prices are deflationary. As I demonstrated last week, for the time being the trade war is not having any meaningful effect on inflation. What is important is the way the market interpreted the cause of the rising bond rates. In the past month, ten-year bond yields rose 38 bps to 3.23% from 2.85%. Real rates represented 85% of this increase. In other words, the bond market perceived that yields rose in response to upbeat economic data and not because it taught that inflation expectation rose.

Thus, the inflation risk is totally associated with the one possibility that wage rates will push costs up. While it is true that the labour market is tight, and the economy is operating at full employment, perhaps strangely, wage growth indicators the Fed most closely watches like the compensation per hour, employment cost index, the Atlanta Fed wage tracker, and average hourly earnings are all supportive of very gradual rate increase. The September report on average hourly earnings shows a one-year increase of 2.80%. Given a year over year productivity increase of 1.50% for the comparable period, real wages rose only 1.30% in the last 12 months. Even if one puts wage growth on track to cross 3% in October, there will be a lot of room left before unit labour costs pass by the 2.0% core inflation that the Fed abhors --- an ample cushion before wage growth reaches

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alarming levels, making the negative comments on wages more hypothetical than probable.

There's been a major disruptive change in the job market that takes away the mystery of why workers' wages fail to keep up with declining unemployment rates. Traditional, nine-to-five jobs have been lost by the millions due to globalization and technology and replaced by the "gig" economy, temporary work, low-skilled immigration, and outsourcing. This has brought about ongoing uncertainty and anxiety, lessening demand for wage increases. Additionally, there are numerous hidden jewels that characterize the shape of the labour market which are very telling. The hidden jewels make it apparent that wages are influence by underemployment. As a matter of fact, the employment-to population ratio is well below the 2000 peak. This untapped potential would explain why wage growth remains subdued--both nominal and real. I listed a few hidden jewels here:

1) A record high 8.0 million adults rely on a patchwork of jobs. The share of multiple-job holders is not declining. It means that people are not transitioning to regular positions with more benefits and better schedules.
2) The latest Challenger Report shows that the economy is generating record numbers of M&A layoffs and retail job cuts.
3) The economy has constantly been able to pull out of the woodwork more people into the job market out of semi-retirement, the disability rolls or out of the parents' basement.
4) In September, the broadest underemployment rate (U-6) ticked up, suggesting that many people still cannot find jobs.
5) A very recent survey by the NY Fed shows that the probability of job losses increased to 16% in September, the highest since November 2016 and up from 13.8% in August.
6) Growth in federal tax collections have been soft--even for wage withholdings and down 20% y/y.
7) As many as 4.7 million new job recruits have not previously been in the working population cohort. Many who are re-entering the job market go directly from "not in the labour force" to "employed" bypassing the "unemployed status."

As one can see, I think that the risk-positive narrative of "growing well without the inflation sickness" is still intact. The Fed Chairman Powell was probably read out of context. Since the policy rate is 2.125% and that's 50% or 125 bps away from the Fed's estimated neutral rate, the market reaction to "a long way" should have been interpreted in terms of time and in amount. This point was well shown in Tuesday's Gartman Letter. It said, "Is the Fed really silly enough to send the curve into inversion?"

The ride for equities might be bumpier going forward but looking at the relationship between stock prices and declining bond prices, stock indices have risen in 12 of the 15 periods or 80% of the time according to a study penned by SunTrust's Keith Lerner. It seems to me that given the size of the stimulus and based on conventional wisdom, the U.S. economy should have overheated long ago. One can conclude that the recovery has longer to run. Put simply, we are still in a bull stock market. The stock market is having a long overdue but healthy correction. The S&P 500 is now trading for a reasonable 15.4X 2019 EPS of $179.

Yet, I know that even intelligent decisions are subject to errors when one does not have all the facts. Bastiat, a famous French economist, said it's what you don't see that counts. That is why overheating is hard to spot and recession tough to predict.

Accordingly, some prudence is warranted because going forward a rogue inflation is a risk-off threat to a risk-asset sentiment for it could disrupt the normalization process and the gradual increase in the Fed's policy rate. Given this strategic risk of more tariffs, wage inflation, rising interest costs I recommend that portfolio managers should be market weight gold, be long volatility and hold some cash to buy dips when they come. Facing this trio of possible headwinds, it may not be a bad idea to focus on companies with pricing power, strong balance sheets and a low percentage of labour cost to sales.

P.S. Much of the inflation data (consumer and producer prices) were on the soft side in August and they were again soft in September.

What Is Going On Internationally: WSJ Headline--Cold War II

Walter Russell Mead, premier geopolitical thinker and a fellow of the Hudson Institute, insists that the U.S. has implemented a cross-government strategy to counter what the Trump-Pence administration considers Chinese military, economic, political and ideological aggression. The US denounces China's "whole of government" approach a rivalry, and vows to

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respond in kind----suppression of Tibetans and Uighurs, "Made in China 2015" plan for tech dominance, the Belt and Road initiative, and water-claims in the South China Sea. The U.S. has already reacted.

1) The Navy plans to greatly intensify patrols in the South China Sea.
2) The U.S. is discouraging trade agreements with China
3) Congress just approved a $60 billion Build Act to counter China's strategic initiatives in Asia and Africa.
4) The White House issued a report highlighting the danger that Chinese-based supply chains pose to U.S. military capabilities.

It's a major shift in American foreign policy and U.S.-China relations. We have gone from a trade dispute to a trade war to a cold war in less than twelve months. Business protests are bound to fall on deaf ears because national security matters more than business interests. Both China, and the U.S. are bound to move quickly, unpredictably and disruptively as they struggle for advantage. In terms of domestic politics, the confrontation may prove to be widely popular. On Thursday morning, the Chinese commerce ministry refuted the allegations, saying that China is not engaged in "economic invasion", has no intention of interfering in U.S. politics and open to restarting trade talk. China said that it "hopes that the U.S. would stop finding excuses for its unilateralism and trade protectionism." It may be a good time to read Graham Allison's book---Destined For War (Can America and China Escape Thucydides's Trap). A few defense stocks might be a good addition to one's portfolio.

New Technical Perspectives as of October 11, 2018—Sevens Report

1) Based on the Dow Theory, the trend for that S&P 500 is bullish with key resistance at 2948 and key support at 2810 —2757 on Thursday morning, through key support. Should rebound.
2) Based on a proprietary model, the trend for Crude Oil is bullish with key resistance at $78.43 and key support at $70.30 —$71.91 on Thursday morning.
3) Based on another proprietary model, the trend for Gold is neutral with key resistance at $1256 and key support at $1159 — $1208 on Thursday morning.
4) Based on a proprietary model, the trend for 10-year treasury yield is bullish with key resistance at 3.44% and key support at3.00%---3.23% 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 bearish again with key resistance at 80.00 US cents and key support at 75.00 US cents---76.01 US cents on Thursday morning.

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