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October 18, 2018

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Oh Canada, Stop Focusing on Marijuana

This is a friendly reminder to investors that Canada is more than just a marijuana economy and they should be taking advantage of this disconnect. As investors' appetite is focused on marijuana, many sectors and companies are trading at very attractive multiples.

The estimated P/E for the TSX is at 15.03x for 2018 and 13.23x for 2019. The S&P is estimated at 17.15x and 15.5x respectively, which is approximately 15% more expensive than Canada. With NAFTA, LNG Canada, and the legalization of marijuana behind us, investor appetite for other Canadian sectors should rise. There is serious value in the TSX and it should not be overlooked. I'm of the opinion that Canada is for sale, and if we get any positive news on Trans Mountain, it will be an additional catalyst to energy equities; a significant sector for the TSX.

Below are a few names that I follow and will give a good understanding of the value opportunity in the market. Some of these companies are trading well below their 5-year EV/EBITDA averages. I continue to see the Canadian market as a great investment opportunity that should not be overshadowed by the hype in marijuana.

Name	2018E EV/EBITDA	2019E EV/EBITDA	EV/EBITDA 5YR Average	% 2018 Below 5 Year Average	% 2019 Below 5 Year Average
Martinrea International Inc	3.6	3.33	4.45	-19.09%	-25.14%
Park Lawn Corp	17.59	12.5	26.05	-32.47%	-52.02%
Dollarama Inc	16.22	14.99	21.41	-24.26%	-29.98%
Alimentation Couche-Tard Inc	10.16	9.63	12.57	-19.17%	-23.39%
Secure Energy Services Inc	8.87	7.5	13.13	-32.45%	-42.91%
Vermilion Energy Inc	7.54	5.7	11	-31.50%	-48.22%
TORC Oil & Gas Ltd	4.98	4.33	7.58	-34.28%	-42.91%
Pembina Pipeline Corp	11.53	11.02	19.19	-39.95%	-42.59%
Parex Resources Inc	3.83	N/A	7.88	-51.47%	N/A
Sienna Senior Living Inc	15.49	14.42	18.33	-15.49%	-21.32%
K-Bro Linen Inc	13.57	10.39	16.52	-17.86%	-37.13%
SNC-Lavalin Group Inc	11.37	9.95	16.23	-29.97%	-38.70%
Savaria Corp	19.64	13.92	26.07	-24.68%	-46.60%
Canadian Natural Resources Ltd	5.51	5.08	9.42	-41.49%	-46.06%
CCL Industries Inc	11.31	10.33	14.2	-20.35%	-27.22%
First Quantum Minerals Ltd	8.23	6.1	13.5	-39.04%	-54.81%
Superior Plus Corp	7.05	5.54	10.08	-30.11%	-45.01%
Algonquin Power & Utilities Co	11.12	11.28	15.35	-27.59%	-26.54%

*The funds hold the above securities.

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■ Mendel's Option Corner

By Robert Mendel

Back from a week off. I could say I was on a big important assignment plotting my next big option move but the truth was I got sidetracked and missed the cutoff. Apparently, this needs to be in by Wednesday afternoon, and not Thursday, so compliance can review and fact check everything. Boy pressure.

And speaking of pressure, other than pot stocks it has been really difficult lately, at least for me. I know you guys think I am right all the time (unlike my wife) but sure enough there must be a loser too, so let's talk about it.

When Whirlpool, the largest maker of home appliances, fell from $185 to under $125 I thought it was the time to sell a put. Tariff issues would be temporary and the pending Sears bankruptcy would not have a material impact on revenue and earnings. Also, this was a company that has faced problems in the past only to emerge better afterwards. So I thought it would be the same this time.

This is what I did. On September 9th I sold 10 Oct 19 120 put for $2.00. This equated to a 1.7% return in 5 weeks ($2/120) or a 17.3% return annually with a 4% downside protection ($125-120/125). Looked good to me. Guess not. The stock proceeded to fall and fall even more. On October 9th, with the stock at $107.50 (a new 52 week low) and the prospect of getting assigned very real, I bought the option back for $12.70 and rolled out to November 16 120s for $14.60 for a net credit of $1.90. Coupled with my original premium received my total net credit came to $3.90 ($2 + 1.90) I simply deferred the issue and am hoping there will be a little rally come November so I can once again roll at more favorable terms. Let's see what happens and will let you know.

An update on NFLX – In issue 29 and 33, I talked about the Oct 19 395 put I was short for a total credit of $24.15. The stock was trading in the $330-345 range and the day was coming where I would have to make a decision. (Friday) But sure enough the stock was rescued by great earnings and as I write this the stock is set to open at around $385. I will still may have to buy it back, or rollover, but as of now I am back in the black overall. Will keep you updated.

Also an update on TSLA – In issue 34 I talked about my short position. Well on October 5th when the stock traded down to $262 I closed the short Oct 360 calls for .20 cents (sold it for over $10). This leaves me with only one more short position – the January 400 calls which I sold for $7.23

Now I need to head to the store to buy a dishwasher, got to help Whirlpool.

Bye.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$9.08	-4.61%
Palos Equity Income Fund - RRSP	PAL101	$6.41	-5.29%
Palos Merchant Fund L.P. (Mar 31, 2018)[2]	PAL500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL210	$8.80	-19.37%
S&P TSX Composite (Total Return with dividends reinvested)			-1.95%
S&P 500 (Total Return with dividends reinvested)			6.67%
S&P TSX Venture (Total Return with dividends reinvested)			-18.37%

Chart 2: Market Data[1]

	Value
US Government 10-Year	3.21%
Canadian Government 10-Year	2.52%
Crude Oil Spot	US $69.75
Gold Spot	US $1,223.70
US Gov't10-Year/Moody BAA Corp. Spread	188 bps
USD/CAD Exchange Rate Spot	US $0.7679

[1] Period ending Oct 17, 2018. Data extracted from Bloomberg
[2] Fund is priced annually

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■ What is New on the Macro Level?

By Hubert Marleau

What Is Going On in the U.S.:

Trade disputes to trade war to cold war--short of bombs and bullets.

China is a very important country and may become the largest economy in the world, larger than the U.S. by 2025. The move of one billion people out of poverty is probably the most important event of the last 25 years. For many Americans, China's economic growth was achieved at their expense. It is based on the notion that the Chinese got where they are by cheating. In order to make sure that the allegation is politically believable, American politicians have put the blame on the bilateral trade deficit with China because it's easy to see and easy to explain to a gullible audience. Turning economics into politics is done all the time. It works because the general population is pretty dumb when it comes to economics. Generally speaking, people tend to trust simpler linguistic verbiage, political skills and rhetoric rather than empirical evidence or valid theories.

In his book "The Moral Animal", Robert Wright argues that the human brain wants victory over truth. When it comes to processing opinions, humans tend to deny them if they are not part of who we are. For example, the presumption that the U.S. is better and more efficient than any other country is a common American belief. In this connection, it is difficult to change their opinion for they tend to latch on to arguments that support what they already believe, ignoring plausible evidence and logic. Generally, people cling to ideas that support their views because they require less patience, less curiosity, and fewer numbers. But when it comes to investments, it is crucial to fight confirmation bias (looking for arguments that support one's view).

In order to achieve this, investors require an open mind, an abundance of accurate numbers, and the use of logic. It facilitates investors to answer some of the basic questions about economic phenomena and make sense of economic complexity. Economic science can demonstrate that the belief that bilateral trade deficits are bad is absurd. The economic reason why the U.S. has a trade deficit is because Americans spend more on goods and services than they can actually produce - they don't save enough.

Then, Why Is Washington Upset--- Fears Beijing?

The U.S. might be a deeply polarized nation, yet the view that the country is at imminent risk of being overtaken by China spans the partisan divide. It's widely believed by republicans and democrats that unless Washington does something to counter the rise of China, America will soon lose its status as the world's leading power. There are many reasons why Americans feel compelled to challenge China's worldwide influence.

1. China has embarked on territorial expansion, staking claim to 80% of the East China and South China Seas. It's Belt and Road Initiative and infrastructure investment in many countries, will link China to Europe and Africa. A massive undertaking that will ultimately be several times larger than the Marshall Plan even in inflation-adjusted terms. Indeed, Beijing has become far more active on the global stage, ramping up its defense spending, foreign aid and international cultural missions. Chinese are seen everywhere; China has emerged into a dynamic enterprise with global contacts at the diplomatic and business levels with a huge diaspora.

2. Measured by purchasing power parity - the IMF's preferred yardstick for comparisons - China is already larger than America. It is the top trading partner of all major Asian countries. China is the undisputed growth engine of the world and its concentration in East Asia has made it a formidable regional power. Allies such as Australia, New Zealand, and Japan have officially told their American counterparts "do not to make us choose between our economic relationships with China and our security relationships with you." Twenty-five years ago, China made up less than 2% of the global GDP. today that number is 16%, second only to the US's 24%. In the next decade, the Chinese economy will surpass the size of America's. Already, nine of the 20 most valuable technology companies in the world are based in China.

3. China has a defined "Made in China 2025" economic strategy to close the technology gap with the rest of the world. Where China really is presenting a challenge is in artificial intelligence. And, the Chinese are not stealing AI: they're at the frontier. They have a big advantage over the U.S. and Europe because they do not have privacy restrictions that

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westerners do. The former head of Google China, Kai-Fu Lee, has written an important book arguing that China is likely to win the race for artificial intelligence---the crucial technology of the 21st century. He points out that China's companies are highly innovative, its government is willing to make big bets for the long term and its entrepreneurs are driven.

4. Then, there is the question of industrial espionage. Bloomberg Businessweek recently reported that the People's Liberation Army inserted specialized spying chips into motherboards bound for servers around the world. We do not know if the story is true for sure but imagine for one minute that it is. Bloomberg is a serious newscaster. The potential intelligence gains could be enormous. Bloomberg Businessweek claims that the tempered motherboards could have gotten inside the CIA, NATO, U.S. Navy ships, etc.… One could question why the Chinese government would allow such a thing, endangering its own enterprise. It should be noted that bureaucracies dealing with national security often pursue objectives different from business agencies.

In response to these presumed threats, Washington is clearing the way for a fight with China. Firstly, the USMCA includes a section that seems to serve no other purpose than to deter Canada and Mexico from forging a free trade agreement with China. Secondly, the U.S. has entered new talks with the E.U. and Japan that may end up with a similar provision, hoping to form a "trade coalition of the willing" to confront China. Thirdly, the Trump administration decided to aggressively police foreign investments through a rigorous review system aimed primarily at preventing China from gaining access to sensitive cutting-edge American technology. And to top it all, US vice-president, Mike Spence, delivered a de facto declaration of cold war against China, saying that President Xi Jinping might no longer be a friend.

The U.S. is confining its economic warfare to a single battlefield. In my judgement and that of others who know a lot more than me, the fight will be a long one. The outright labelling of China as the enemy is a seismic shift in U.S. strategy. It will certainly trigger a tough Chinese response for three big reasons: humiliation, dependency, and resolve.

China has suffered enough humiliation as a consequence of upheaval from war, colonialism, and revolution. Many Chinese citizens want to do away with past eras of humiliation when the country lost huge chunks of territory and of sovereign rights to small rivals like the U.K. and Japan. The Communist Party is determined not to go back there. China is compelled by its own history and domestic policy to respond hard, and can't be seen as appeasing the U.S.. The rhetoric from Mr. Xi is powerful, casting aside illusions of inferiority and reducing the need to rely on others. State capitalism is an effective way to attain goals of excellence in artificial intelligence, 5G telecoms, the internet of things, self-driving cars, and advanced batteries.

China has de-risk its dependence on America. Firstly, the value of products made by U.S. companies in China and sold in China totals about $250bn, almost double the $130bn in products imported from America. Research finds that in 8 of 11 technology sectors, the sales in Asia of products made in the E.U., Japan, South Korea and Taiwan outstrip those of products made in the U.S.. The U.S. has a clear dominance only in semiconductors, semiconductor equipment, and aerospace.

According to a recent article in the Barron, China's economy may be growing at a slower pace, but it is still growing much faster than any western economy. "What is striking is that the importance of exports has collapsed. In twelve years, exports have declined from about 35% of N-GDP to 16% today---about the same as the U.S." Since a decent chunk of the value of Chinese exports still come from imported components, the aforementioned figure is probably overstated. Only an eighth of what China actually produces ends up going abroad. The Chinese economy is not as open as some believe and this allows the country to become increasingly authoritarian and to get its way with neighbouring countries.

Is There a Winner? A long Stalemate for Now

Anatole Kaletsky, a leading expert on China and chief economist of the highly reputable Gavekal Dragonomics opines that based on Ricardo's concept of comparative advantage and/or Keynesian demand management, either the U.S. or China will sue for a trade truce or peace.

Graham Allison, a leading expert on geopolitical issues, thinks that the Trump administration's strategic thrust is more aspirational than

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operational. In his opinion, strategy requires an alignment of ends, ways, and means. "At this point, Trump is longer on ways than the other two". So far, we've seen tariffs, rules on investments, screening of supply chains for national security vulnerabilities, increased military spending by $82bn and the creation of a new foreign aid agency (United States International Development Finance Corporation) to provide $60bn in loans, loan guarantees and insurance to companies in order to bankroll infrastructure projects in Africa, Asia and the Americas. Additionally, President Trump claims that China is manipulating its currency.

The staff at the Treasury department deems a country to be a currency manipulator if there is a minimum $20 billion trade surplus with the U.S., a current account surplus in excess of 3% of N-GDP, and repeated interventions in the currency markets. The renminbi has tumble almost 10% against the dollar over the past six months. China met the strict set of criteria, yet Secretary Mnuchin stopped short of naming China as a currency manipulator.

As referenced earlier, Vice-President Mike Pence made a speech showing that the administration is orchestrating a far-reaching campaign against China. Chinese officials were flummoxed. Consequently, the logic of this confrontation is unquestionably related to China's rise. It's not a matter of political rhetoric or trash talk for the midterm election campaign. Although, we are without the benefit of core strategic documents like George Kennan's long telegram and Paul Nitze's NSC-68 policy paper that crystallised U.S. strategy in the last cold war, it's evident that the U.S. fears for its prosperity and security and does not want China to encroach on America's accustomed position in the world. The U.S. is in an existential conflict with China for global dominance. This can only be achieved by maintaining economic superiority.

Now that we know the objective of this conflict is to bring back to America things, it considers to be important like key industries and the way the U.S. intends to go about it, we need to know if it has the means. Overreacting to fears of the ascent of China and the American decline is dangerous for it leaves both countries vulnerable to third-party provocations. Fareed Zakaria, a shrewd political analyst, reminded us in a recent Washington Post article that "the last time there was such a question - when Britain confronted a rising Germany 100 years ago - it did not work out so well for everybody involved". As I suggested last week, it may be a good time to read the ancient Greek historian Thucydides. He argued the origins of the Peloponnesian war lay in the "fear" that the rise of Athens instilled in nearby Sparta.

Does China Have the Capability to Become a Superpower and Imperil U.S. Hegemony? Maybe in Eight Years

I had lunch on Tuesday with the executive chairman of Ivanhoe Mines and the president of CITIC. They know China much better than me. They argued that it would take about 8 years to find out. Secretary James Mattis played down tensions with Beijing, saying the U.S. was "not out to contain China". Right. China cancelled high-level security talks with Mattis that had been planned for mid-October. Meanwhile, a U.S. and a Chinese destroyer had a close call in the South China Sea. The thing is that it's very expensive to be a superpower.

Maintaining economic power, military power and soft power is a costly proposition. The more China extends itself around the world, the heavier the burden. The Chinese general Sun Tzu wrote in "The Art of War", "first count the cost." I've concluded that China surely wants to dominate in Asia. Based on economic growth, population size and defense spending, it will, at the regional level, well outstrip the U.S. in 8 years. I do believe that China wants more and wants to set its own rules around the world or, at least influence them. Readings coming out of the Middle Kingdom show clearly that China wants to hollow out the U.S. economy, undermine democracy around the globe and control the world-wide diplomatic chessboard. The question is whether China has the capacity of to be a global superpower. Trump and company certainly do.

Alice Lyman Miller, China scholar at Stanford University's Hoover Institution, and former CIA analyst, wrote "a superpower is a country that has the capacity to project dominating power and influence anywhere in the world, and sometimes, in more than one region of the globe at a time, and so may plausibly attain the status of global hegemon." Unfortunately, it is difficult to measure the overall power of a country---it's not just about GDP. "Foreign Affairs" has a good explanation. "To become a superpower, by contrast, a country needs to amass a large stock of economic and military resources. To do this, in turn, it must be big and efficient at the same time - not one or the other. It must not only mobilize vast inputs but also extract as much as possible from these inputs.

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In short, a nation's power stems not from its gross resources but from its net resources - the resources left over after subtracting the costs of feeding, sheltering, policing, protecting, and servicing its people." To get an accurate sense of China and the U.S. overall power, I found research at the World Bank and the United Nations who have taken this task of publishing rough estimates of countries' net resources and at Credit Suisse who publish data on countries' net stock of privately held wealth.

These three databases show that the United States' net stock of extra resources and wealth is several times the size of China - in the trillions of dollars. Given the growth differential between the two nations, the conventional wisdom is that China is a juggernaut set to overtake the U.S. as the world's dominant power. This, of course, will be dependent on the success of "Made in China 2025" and the "Belt Road" initiatives; and how the West responds. I understand why Americans fear that the rising power of China is challenging the ruling hegemon. It's why the U.S. is willing to "hit China early and hard".

Maybe, we shall know in 8 years how it all works!

New Technical Perspectives as of October 18, 2018—Sevens Report

1. Based on the Dow Theory, the trend for that S&P 500 is bullish with key resistance at 2868 and key support at 2654 —2809 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 $77.04 and key support at $67.53 —$69.11 on Thursday morning.

3. Based on another proprietary model, the trend for Gold is neutral with key resistance at $1256 and key support at $1187 — $1226 on Thursday morning.

4. Based on a proprietary model, the trend for 10-year treasury yield is bullish with key resistance at 3.31% and key support at 3.00%---3.18% 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 again with key resistance at 79.75 us cents and key support at 75.26 us cents---76.21 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