PALOS

November 1, 2018

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

The Selloff Brings Long Term Investment Opportunity

If we haven't hit bottom on the Canadian market, we must be getting there soon. In the month of October, the Canadian market corrected by approximately 10%, and don't forget the Canadian market prior to the October sell off was pretty much flat for the year. What is intriguing with the Canadian market, is even before the selloff of the market, it was already inexpensive compared to its 5-year average. Here are some interesting numbers, the forward P/E and the actual P/E for the TSX prior to the selloff were approximately 15.5x and 17.5x respectively.

What is even more interesting is where the P/E ratios are trading now after the October selloff. The forward P/E and the actual P/E are trading at 14.6X and 16.5x. In both scenarios they are trading below their 5-year lows. There are many reasons for the multiple contraction, such as Interest rate, oil deferential, NAFTA, Tariffs, midterm elections, etc… However, fear and confusion bring opportunities and should be seen as good buying opportunities. Many sectors in the Canadian markets are now trading at very attractive levels. For example, energy, energy infrastructure, utilities, industrials, telcos, and materials are all trading at very good values. There is something to be said when stocks like Bank of Nova Scotia (TSX: BNS) and Inter Pipeline (TSX: IPL) are yielding 5% and 8% respectively.

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$8.73	-8.27%
Palos Equity Income Fund - RRSP	PAL101	$5.83	-8.55%
Palos Merchant Fund L.P. (Mar 31, 2018)[2]	PAL500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL210	$7.94	-26.47%
S&P TSX Composite (Total Return with dividends reinvested)			-4.99%
S&P 500 (Total Return with dividends reinvested)			3.01%
S&P TSX Venture (Total Return with dividends reinvested)			-24.45%

Chart 2: Market Data[1]	Value
US Government 10-Year	3.14%
Canadian Government 10-Year	2.49%
Crude Oil Spot	US $65.31
Gold Spot	US $1,236.10
US Gov't10-Year/Moody BAA Corp. Spread	203 bps
USD/CAD Exchange Rate Spot	US $0.7600

[1] Period ending Oct 31, 2018. Data extracted from Bloomberg

[2] Fund is priced annually

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It seems that the market has been focusing only on the risk and not on the opportunities, such as LNG Canada, NAFTA resolution, and marijuana legalization. All mentioned activity should translate to positive GDP in the coming years.

For full disclosure, I have been personally buying the fund in this drawdown period as I see significant value to be had.

■ Mendel's Option Corner

By Robert Mendel

It's Halloween, and it seems the bulls were scared off by the ghosts. I am declaring the rout over, mostly because all the stocks are down 70%. Well ok, I am exaggerating, but it sure feels like it.

Everywhere I turn people are so nervous and asking me if they should cash out. That is the sign of a market bottom, not a top. And people are also asking me how I am doing in these markets, that for sure I must be getting killed because I play options. But while I am certainly down on some positions, the beauty of this approach is that it allows me downside protection, so I am not really down too much. In fact, I am actually making money in many areas too. How you say? Remember when I sell puts I am selling premium, so time is on my side. Case in point is the Boeing I wrote about last week where I sold the Oct 26 350 put. While the stock came down it did not fall below $350, so my put expired worthless.

And this week with the stock at $343 I reloaded by selling a Nov 09 322.5 put for $3.40, a play that will yield me 1.1% in 10 days (38.4% annualized) and will do so even if the stock falls another 6%. So yes, the stock came down and was beneath $350 but remember it has to fall below a certain point AND by a certain date. (I went for more downside because there was a plane crash in Indonesia)

Let me give you an update on Netflix 395 put position. I was assigned yesterday and am now sitting long the stock. I looked around and found no options that I currently like. So, for now I will keep my stock. As mentioned I have put a total of $28.05 in my pocket, so my cost is $366.95 – far away but then again this is Netflix, so you never know.

Yesterday Amazon touched $1476 before bouncing back up above the $1500 level. It was at this point I received another call – and this from my neighbor – telling me he just sold his entire Amazon position he bought just two weeks ago (he didn't tell me how much he lost, and I didn't ask) So I did what I normally do, I take the other side. I sold a Nov 02 1475 put for $26.50, a 1.8% return in 3 days if it holds above the magical $1475 level.

Let's see what happens…keep you guys informed and remember don't eat too much candy…

■ What is New on the Macro Level?

By Hubert Marleau

The Weekly Narrative: Week Ended November 1, 2018:

What Went on in October Was Not Systemic

October was turbulent and a bad month for Canadian and U.S. equities. The market value of U.S. and Canadian common stocks sank 6.9% and 6.7% respectively. The worst month in eight years with the S&P 500 on the cusp of correction territory. There were a superfluous number of moving variables that played a major role in forming a bearish expectation in the marketplace which, in turn, were not really driven by fundamentals.

Yet, it's safe to say that investors want to know what happened and why because they worry that routs could be systemic. There was a lot of hysterics in the media such as late-cyclical fright, maximum point of fiscal stimulus and peak earnings growth that combined with worries about Fed policy mishaps. The October narrative morphed from a short morning tale that forced a de-risking episode following an acute disorder in bond markets into a late-night story that the recovery-cycle is ending, and the Fed was not going to do anything about it. What is unusual is the relative performance of the credit spreads versus the equity markets.

Goldman Sachs came out with concrete numbers showing that simple univariate regressions of monthly percentage spread changes on monthly S&P 500 returns over the post-crisis period suggest that both the investment grade and high yield bonds have outperformed their beta of the S&P 500. And, this took place within the conventional range of what constitutes confidence. As a matter of fact, the underreaction has even been stronger because the growth-sensitive CCC-rated bonds. This is very surprising to me for the cyclical stocks have sharply underperformed the defensive stocks. Yes, credit spreads for all grades of bonds are

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wider against treasuries, but not that much. In this connection, one would wonder if the credit market is underreacting or the equity market is overreacting. Acknowledging that bond investors are smarter, more seasoned, more right and less nervous than equity players, I'm in the camp that believes that the October rout is not systemic.

Let's Be Clear, There Is No Bad News About Growth, Profit and Inflation.

The American economy cooled in the September quarter, a slight slackening in growth than was widely anticipated. GDP grew at the annual rate of 3.5%. Many analysts pointed out that if it had not been for a buildup of inventories, growth would have been much lower. Nevertheless, I believe that the GDP numbers were good. Consumer spending was strong, rising at the annual rate of 4.0% without a material decline in the personal saving rate. The University of Michigan signaled that consumer sentiment is very good and the Conference Board reported that an October surge in consumer confidence - an 18-year high. Is not natural for businesses to put stuff on shelves, after several months of drawdown in inventories? As a matter of fact, economic growth would have been much stronger if it had not been for a 9.0% surge in imports that brought about a huge trade deficit that is probably transitory due to the incoming tariffs on imports - China registered larger monthly trade surpluses during Q/3.

It is very possible that the trade deficit and the inventory build is related. If one were to net these two items out, GDP growth would have been about 0.25% better. According to my Recession Dashboard which is updated daily with informative monetary, financial and economic data, we are a far away from a recession. During the month of September, real disposable income increased 2.9% y/y. However, the Wall Street Journal estimates growth will slow to 2.5% by the first quarter of 2019, to 2.3% by Q/3 of 2019; growth should settle around 2.25% in the ensuing years, resulting mainly from productivity gains not from employment gains.

I will not go into the internal parts of the parade of Q/3 earnings that U.S. companies reported during the month. Suffice it to say that earnings were impressive and generally better than expected. It would be an error to attribute the October turbulence to the Q/3 earning season. According to FactSet, third quarter earnings for companies in the S&P 500 are on track to increase 23% year-over-year, down a bit from 25% in Q/2. Currently, sales and earnings growth are just a tad under last quarter. Here is how Q/3 is stacking up vs Q/2, according to "The Launch Pad". "Sales growth 8.7% vs 9.3%, companies growing earnings was 86% vs 85%". The bottom line is that EPS of companies in the S&P 500 are expected to rise 24% in 2018 and to slow down to 10% in 2019. It's actually pretty good. That 10% has nothing to do with the tax cut - the expected profit increase will come from organic growth and share buy-backs.

It should be noted that the quest to increased profitability through productivity is vigorously on. Capital expenditures on "Software and R&D" and "Information Processing Equipment" in real terms totaled $1350bn in Q/3, representing a yearly increase of 8.8% - in real terms (inflation adjusted). This is why productivity is on the rise. These productivity enhancement investments account for almost 7.3% of R-GDP---historically high and among the highest in the world. The investment and economic picture is changing immensely. Businesses are plowing big money into new software like artificial intelligence and machines like robotics--and they have been doing so for the last three years. It means that worker productivity will rise, allowing the economy to grow faster without causing heating inflation.

The GDP price deflator which is a reflection of the price level for the entire economy rose at the low annual rate of 1.4% in Q/3. What is particularly interesting was the sequential slowing in the core PCE deflator to a 1.6% annual pace from 2.1%. In fact, the year-over-year trend was right on the Fed's target at 2.0%. There is no evidence that inflation is set to noticeably overshoot the Fed's objective. The worry over wage inflation looks to be overdone. Fresh September data shows that compensation of employees, wage and salary disbursements and supplements to wages, all rose at the annual rate of 2.4%. I have no doubt that productivity gains did better than an annual rate 0.4% in September.

Then What Went Wrong? Where's the beef?

The fact of the matter is that there are more ambiguities when you reinstitute the unconditional interpretation of economic data - meaning strict elucidation of data dependence--you revoke the market's license to consult. Chairman Powell uses plain language, stating the obvious----if the economy does well then, the Fed will proceed with policy tightening. Therefore, the Fed and the bond traders are no longer in a two-way communication loop. No one

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understood what Powell meant when he said; "we're a long way from neutral on interest rates". Did he mean in time or in amount?

This is not good because the Fed's newfound data-dependency means there can only be a compelling economic rationale for hiking, pausing or cutting. Given that bond traders acknowledged that Powell is not on their team and has decided along with the majority the Fed governors to do what the economic data dictates rather than allowing the market to co-author the policy script, they figured that they should do their own price discovery. Being a cautious bunch, they took the most prudent decision and sold bonds. The cost of capital rose forcing a stock-price adjustment.

What is Next? The Fed Will Pause by March 2019

There are very good reasons to think that the current "policy rate" may be near what is considered to be the "neutral rate". Interest rate sensitive sectors are showing signs of wobbling. Residential construction, non-residential business investment, consumer spending on autos did not fare well in Q/3. In other words, the rise in interest rates and the narrowing of the yield curve that we've all witnessed since the third quarter of 2016 is having its toll on the cyclical segments of the economy. The Fed has raised the federal-funds rate eight times in the past 3 years and inflation stands at the 2% goal.

The goal is not a hard ceiling and the symmetrical objective of full employment and price stability gives the Chair some flexibility to see if the policy rate is close enough to the neutral rate to warrant a pause. Two governors, one from the Dallas Fed and the other from the Minneapolis Fed, have taken notice and are putting pressure on the Fed chair to take a breather. Such an outcome would help because the market thinks that the Fed is about to raise interest rates too fast for the aforementioned reduction in the growth rate and the anticipated stability of the inflation rate. In this connection, for as long as inflation is subdued, why should the Fed raise interest rate at all? I hold a neutral rate in my mind, and it's not the official 3.00% - it's more like 2.50%.

The bottom line is that financial conditions are considerably tighter than the policy rate suggests. In order to get a better idea of where financial conditions lie, I regularly monitor not only the longer-term riskless interest rate but other measures such as credit spreads, the exchange rate, equity valuations and availability of bank reserves. Financial Condition Indices provided by Bloomberg, Goldman Sachs, the Chicago Fed, the IMF, the St-Louis Fed, Kansas Fed, and the OECD that have similar features to the ones that I use are all suggesting the same——financial conditions are less accommodating than the Fed suggests.

Without getting into algorithmic specifics, a quant-consensus is forming that the "Powell put" is somewhere between 2450 and 2500 on the S&P 500. This is an interesting point because it like an insurance. If the interest sensitive segments of the economy and market gets out of hand, the instability could change the tone, if not the direction, of monetary policy - the next FOMC meeting is November 8.

The Outlook Is Better- Rolling Out to Rolling In

Many analysts that think that the global stock markets are now flushed out and effect of changing interest rate on the global bond market is also rinsed out last Monday because these two global markets were forced to digest two big geopolitically important events that could have implications going forward. In Europe, German Chancellor Angela Merkel, the effective leader of the EU, announced the beginning of the end of her reign as leader of the CDU party leader. In America, Trump Administration reported that he was prepared to slap tariffs on everything that China ships to the U.S. if upcoming talks between President Trump and Xi Jinping do not break the two-month-old trade stalemate at the G-20 meeting in November. If, indeed, these last two episodes has flushed out the weaker investors and/or exhausted the remaining ammunition of the quants, some of the Wall Street bullish forecasts may pan out.

1) JPMorgan's Kolanovic, one of the smartest in the room, says that "with investors positioned defensively, and leverage rapidly coming out of the system, there is an elevated risk of market reversion into year-end". He sees a) the need to boost equity exposure to replace losses incurred in October, b) buyback activity to take advantage of lower prices, c) a drop-in volatility, d) a reduction of current elevated short position and e) year-end performance chase.

2) David Bianco at DWS noted the "S&P 500 usually gains 15% plus in six months after a

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correction after a correction without recession".

3) Yardeni Research, one of the on the best economic research machine on the street, cut its year-end forecast for the S&P 500 a few hundred points to around 2900.

4) David Kostin, another heavyweight, at Goldman Sachs thinks that the rout has gone too far and has overshot the fundamentals. He said: "We continue to expect EPS growth of 7% in 2019 enough to support a S&P 500 rebound to our yearend target of 2850. The resumption of discretionary buybacks should also provide a tailwind".

5) Scott Minerd, head strategist at Guggenheim, anticipates a 15% to 20% rally between now and the end of next year based on cheap forward multiples.

6) Halloween marks the beginning of one of the most seasonally favorable periods of the stock market calendar. I have no explanation for this regularity that over the last century, almost all of the stock market's gains have been produced in the Halloween through May-Day period----the so called "winter months". In contrast, the market has been little better than flat, on average, during the "summer' months. This seasonal pattern goes by the names of "The Halloween Indicator" and "Sell in May and Go Away".

Despite these bullish forecasts, I admit that not everything is rosy. The big picture risk is that the Fed is trimming its balance sheet, while the U.S. treasury is selling more debt to finance a gaping hole in the federal budget and many foreign banks are de-dollarizing their official reserves. This needs to be watch because if too many dollars are drawn for the global financial system, interbank liquidity could dry-up. Fortunately, we are not there and might never get there either. They are reasons for optimism, real yields on treasuries are rising pointing to economic strength, the U.S. dollar is strong indicating foreign inflows of money, financial assets are cheaper, the CBOE Skew Option Index is lower suggesting that investors are not fearful of a black swan event and investors are now positioned more defensively.

Above all, the recession risk, the real killer of bull markets, remains low. Yesterday, Moody's Analytics reported that the risk of having a recession in the next six months is only 11%, up from 10% in September. Yet, prudence pays. That is why investors should buy cheap stocks with strong balance sheets and visible upside potential.

An Aside on Productivity---The Idea Is Getting Attention and Traction

P.S. As you know, I've expressed may times optimism that America is on the brink of a productivity breakout. Richard Clarida, the new Vice-Chairman of the Federal Reserve Bank, in his first public speech called a productivity pick-up is real possibility that deserves close monitoring. The capabilities of AI are starting to diffuse widely as wave of complementary innovations is being developed and implemented.

There is a growing awareness among Fed Governors and Fed Researchers that important consequences on the structure of the economy, the efficiency of operations, output per hours worked, economic growth and inflation are happening, stemming from productivity. This all-important factor is hardly discussed in media and it's not getting the attention of investors. There are now more technology enhancements taking place in the traditional industries than in the technology sectors---that is what is meant by diffusion. The Bureau of Labor Statistics reported that productivity grew at the annualized rate of 2.2% in Q/3, up 1.3% on a year-ago basis. Increases of this magnitude makes wage gains affordable and prevents them from raising unit labour cost and core PCE inflation above the Fed's 2.0% target rate for inflation.

What's the Deal Between the Stock Market and Recessions

In a few weeks, I will empirically demonstrate that the stock market does not anticipate recession and that bear markets starts when a recession starts. It is a false assumption that the stock market is a forward-looking recession indicator. It's a more of a coincident indicator. I will explain why in a future commentary. Suffice to say that bear markets that arise out of a recession are deep and have long "L" recoveries while those that are not but resemble corrections are fast and short and quickly bounce in "V" shaped recoveries.

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New Technical Perspectives as of November 1, 2018—Sevens Report

1) Based on the Dow Theory, the trend for that S&P 500 is bullish with key resistance at 2809 and key support at 2554 —2725 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 $70.99 and key support at $64.22 —$64.98 on Thursday morning.

3) Based on another proprietary model, the trend for Gold is neutral with key resistance at $1269 and key support at $1187 — $1225 on Thursday morning.

4) Based on a proprietary model, the trend for 10-year treasury yield is bullish with key resistance at 3.21% and key support at 2.94%---3.12% on Thursday morning.

5) Based on a Palos Currency Model, the trend for the Canadian dollar turning neutral with key resistance at 78.15 us cents and key support at 75.23 us cents---76.33 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