Issue 45

PALOS

November 8, 2018

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Wow!!! This Market is Nearsighted and Unforgiving!!!

The fund had a few names that missed numbers on timing issues and margin compression. I wish I could tell you that all our companies always beat street estimates, but that would be a lie. It seems that investors and algorithm traders are only concerned about quarterly results and are ignoring the long-term business plans of these companies. Here are few companies that we own in the fund that reported messy quarters and got sold aggressively. My view is that investors are way too nearsighted and ignoring the long-term opportunities. For example:

- **CCL Industries Inc (TSX: CCL/B)** reported strong revenue numbers. However, one of their segments underperformed and brought their margins lower. Market reacted with an 11% sell-off in the morning before settling down 5.83%. Despite the margin headwinds, CCL remains a long-term growth story with an excellent track record.

- **NFI Group Inc (TSX: NFI)** reported an EBITDA miss, mostly on costs related to the new Kentucky parts facility start-up. Excluding these costs, EBITDA was within consensus numbers. Market reacted with an 14% sell-off in the morning before settling down 13.1%.

- **ATS Automation Tooling Systems Inc (TSX: ATA)** reported results below expectations. However, they also announced a record backlog and bookings, signaling continued strong results in the coming quarters. Revenue was lower than forecast on foreign exchange and what seems to be a timing delay from a large project. This project delay revenue is expected to be booked next quarter. Market reacted with an 14% sell-off in the morning before settling down 7.96%.

- **Jamieson Wellness Inc (TSX: JWEL)** reported results that were just shy of expectations. Market reacted with an 22% sell-off in the morning before settling down 11.3%. In my opinion nothing in the results and guidance raises any concern. The market is also ignoring its 5-year partnership with MedPlus, India's second largest pharmacy. In addition, JWEL is expected to receive 9 Blue Hat certifications for the China market.

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$8.93	-6.15%
Palos Equity Income Fund - RRSP	PAL101	$5.96	-6.57%
Palos Merchant Fund L.P. (Mar 31, 2018) [2]	PAL500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL210	$8.24	-23.63%
S&P TSX Composite (Total Return with dividends reinvested)			-2.83%
S&P 500 (Total Return with dividends reinvested)			6.91%
S&P TSX Venture (Total Return with dividends reinvested)			-20.85%

Chart 2: Market Data[1]	Value
US Government 10-Year	3.24%
Canadian Government 10-Year	2.54%
Crude Oil Spot	US $61.67
Gold Spot	US $1,225.20
US Gov't10-Year/Moody BAA Corp. Spread	197 bps
USD/CAD Exchange Rate Spot	US $0.7626

[1] Period ending Nov 7, 2018. Data extracted from Bloomberg
[2] Fund is priced annually

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- **Keyera Corp (TSX:KEY)** also reported a quarter that was below expectations and the market reacted with a 12.5% sell-off in the morning before settling down 5.78%. However, the market seems to be ignoring its new 50/50 JV with CPPIB backed Wolf Midstream to potentially develop an NGL system between the Montney/Duvernay and Edmonton. This is a huge opportunity for KEY.

My father always told me that investing is not a sprint, but a marathon. The investors, however, seem to be attracted to immediate gratification and are forgetting the long-term investment thesis. We see this algorithm and nearsighted price action on the above companies as an opportunity. I see significant value in their business plans, not to mention the overaction in the stock prices has also brought compelling fundamental value.

■ Mendel's Option Corner

By Robert Mendel

The Big Apple. No, I am not talking about the city, rather the stock. Apple was set to report last Thursday on Nov 01 after the close and it took a bite out of my profits. Let me explain.

Right before the close with the stock trading at $217.70 I sold 5 Nov 02 215 puts for $4.50. This was to be a one-day play. Apple reported and while they beat both on the top and bottom line, they said they would not be as forthcoming with specific info as they once were. Imagine I tried that with my wife…

So what happened? Friday morning the stock fell and opened at $209.55 and while it did rally briefly to over $213, closed at $207.48. But if I didn't want to take possession I would have to roll. And that is what I did. I bought back the Nov 02 puts for $9.25 and went out one week and sold the Nov 09 215s for $10.70 for a net credit of $1.45 bringing my total premium received to $5.95. So now my cost, should I be put the stock is $209.05. I am hoping for a bounce sometime this week where I could then roll once again, but this time at more favorable prices. Will keep you posted, and Marvin, hang tough on your position.

I really have nothing else to say but I do have to fill some space so let's speak about the Big Apple… Actually, never mind.

Until next week.

■ What is New on the Macro Level?

By Hubert Marleau

The Weekly Narrative: Week Ended November 8, 2018:

What Are the Three Big Ones: Employment, Productivity and Inflation

If one gets these three big ones right, one will get the path of the economy right and, in turn, will get the policy rate, the riskless long-term interest rates and stock market returns right. There is empirical evidence and theoretical validity that over time, changes in N-GDP and the performance of financial assets holds well. While history suggests that investors should have confidence in the aforementioned relationship, they should know that short term diversions from trends can occur from time to time due to changes within financial conditions. In this connection, it's crucial to understand the employment situation, the state of productivity and inflationary conditions at all times in the context of monetary policy.

The Employment Situation:

The Bureau of Labor Statistics (BLS) provided last Friday, the latest snapshot of the U.S, employment situation. Employment, one of the underlying fundamental drivers of the economy, is strong. The economy added 250,000 jobs in October and the unemployment rate held steady at a 49-year low of 3.7%. It would have fallen to 3.4% if it had not been for an increase in the share of population participating in the labour force. It's interesting to note that job openings exceeded 7.1 million and that is as many as the number of workers seeking jobs. There appears to be many potential workers still on the sidelines, ready to enter the workforce. The statistics are revealing. We are not going to run out of workers for next few years.

1. The share of Americans in their prime working years, between 25 and 54, who are working or looking for work is 82.3%. Viewed differently, the proportion of prime-working-age adults who were working in October was 79.7% compared to 81.9% in April 2000. Theoretically, 2.6% of that cohort could still fill current job openings. As one can readily see, the economy has the potential to absorb this remaining labour slack. The labour participation rate of all the people that could work rose two tenths to 62.9% which helped bring more people into the labour force. This was confirmed by a two tenths

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uptick in the employment-to-population ratio to 60.6%. The household survey reported big numbers - the labour force grew by a whopping 711k in October and 420k in September. These entrants into the labour force explain that despite strong employment increases, the unemployment rate did not change.

2. It should be carefully noted that there is no evidence that an economy ever runs out of workers during an economic expansion. In all business cycles, the year-over-year rate of job growth was always positive at the onset of a recession. It has never been negative. Market Watch observed in a recent report that the average pace of job growth across all business cycles at the time of recession was 1.8%. Currently, there are 95.6 million people that are neither working nor looking for work. This broad-based unemployment measure improved ever so slightly to 39.4% in October, down from a high of 41.8% in 2011 but up from 35.2% in 2000. To be fair the number includes old folks and students. Yet, it should be noted that people work into their old age more and more and students do eventually enter the labour force.

The State of Productivity:

In theory, a sustained increase in productivity looks simple. But in fact, it is not simple. An economy's productivity, or R-GDP per employment, is a function of the capital stock, the education level of workers and a vague residual known as "total factor productivity". The latter is a function of how labour and capital is organized. In order to understand this better, allow me to refer to the productivity surge of 1870 to 1930. During that period, physical capital such as buildings, machines and infrastructures including government and private schools were constructed. Businesses utilized these factors of production in a way to raise productivity. I'm of the firm opinion that a similar phenomenon is in process. My readers know that I've expressed, many times, optimism that America is on the brink of a productivity breakout.

During the 2010-2016 period, productivity increased at the very slow annual rate of 0.35% and it actually decreased in 2016. There are signs of improvement, at least by recent standards. An awareness of a pick-up in productivity is starting to get some traction. Richard Clarida, the new Vice-Chairman of the Federal Reserve Bank, in his first public speech suggested that a productivity pick-up is a real possibility which deserves close monitoring. There is a growing awareness among Fed Governors and Fed Researchers that important consequences of the structure of the economy, the efficiency of operations, output per hours worked, economic growth and inflation are happening, resulting in improved productivity.

Big productivity gains have started to show up in the statistics. In the 18 months ended September 2018, gains in productivity averaged 1.0%. For the six-month period between April and September, worker productivity beat the 2% annualized growth rate that I am banking on for the future. I don't think that I'm being overly optimistic. During the late 1990s and early 2000s, yearly productivity gains routinely beat 3%, sometimes exceeded 4% and occasionally touched 6%. Under historically low unemployment rates, companies hire less-skilled workers to fill jobs which results in a drag on productivity. But by the same token, low unemployment incentivizes them to invest aggressively to help their workers to become more productive. Companies have spent an awful lot on advanced technology.

As I mentioned in last week's commentary, the quest to increased profitability through employment cuts and productivity is vigorously on. Capital expenditures on "Software and R&D" and Information Processing Equipment" totaled $1350bn in Q/3 of 2018 and in real terms, representing a yearly increase of 8.8%. These exceptional increases having been going for three years. Consequently, the economic picture is changing immensely as businesses are plowing tons of money into new software like artificial intelligence and robotic machines. What is particularly interesting for future growth is that the capabilities of AI are starting to diffuse widely because a wave of complementary innovations is being developed and implemented.

Actually, more technology enhancements are taking place today in the traditional industries than in the technology sectors - that means diffusion is happening. A broadening out of cost efficiency is spreading and it seems as if it's resulting from productivity enhancements. The Challenger reported, last week, that layoff announcements were 154% higher than last year and revealed a record number of CEO changes. GM, Wells Fargo, Verizon and a bunch of other multinationals are announcing large buyout offers. For example, GM showed buyout offers to

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18,000 workers, more than a third of its North American workforce.

Inflationary Conditions:

Inflation is a complicated process and the connection between input cost and output prices is not straightforward because expectation can disturb what would appear intuitively correct. Right now, a late-cycle inflation concern is the primary thing on investors' mind. I don't think it should be. The PCE deflator has been rising at the yearly rate of 2% every month since March 2018. Given that agricultural prices and raw material prices are under downward pressures, inflation concern centers around labour cost. Average hourly wage growth of 3.1% year on year is the fastest since the Great Recession ended. This growth should not be considered high—especially when one considers the fiscal stimulus and monetary push that's going on. Investors are so busy grappling with the consequences of the last wave of wage increases that they fail to see what is happening and coming. I have three explanations.

1. Deglobalization might be on people's lips because the focus is on the border wall and goods in container ships. However, what people are missing is the "gig" economy which is facilitating the rise of a global marketplace for online labour. It's the new taut of globalization in its rawest form, it's non-visible but vast and it's upending traditional employment. This gig economy platform focuses on a service sector of the economy where work is done remotely - even in a bedroom. Individuals break up a job into a series of tasks from data entry to translation to coding or to copywriting. They offer these tasks on platforms including Upwork, Freelancer and Fiverr, whereby workers can be anywhere in the world, placing "bids" to do work on offer. This sector of the gig economy is named "human cloud". This whole business gives talented people around the world the opportunity to access global demand. In the human cloud, the sense of competition is visceral, creating an oversupply of labour due to the growing global connectivity. There are literally millions of freelancers, here, there and everywhere, that are prepared to be at Starbucks or on the beach. Competition keeps price down.

2. Wage growth is another concern on people's lips. It's conventional to think that rising wages will lead to higher inflation. Rick Rieder, chief investment officer at BlackRock, laid out a contrasting view on how wage growth influences inflation. The textbook teaches that companies tend to pass on the extra cost of higher worker pay to their customers by raising consumer prices. According to Rieder, the logic is not entirely correct because competition can obstruct the schooling rational. "Under domestic and global competition, too high wage demand can dampen growth and, in turn, inflation pressures. Experience shows that companies often tap the brakes by reining in plans to expand".

3. Unit labour cost pressures remain moderate. According to the NFIB Small Business Survey, it is encouraging in that the y/y growth rate of labour cost has been moderating over the past four quarters from 2.5% to 1.5%. I grant that wage rates have picked up lately. Average hourly earnings for all workers increased 3.1% through October. But, when one takes into consideration productivity, the inflation story changes in the twelve months ended October 2018, productivity grew 1.5%. This is better than the Goldilocks scenario. The net effect on core producer price is only 1.6%. It's hard to figure out where the other 0.4% is going to come from when all other input cost like raw material cost is falling.

Conclusion:

Recessions do not begin because there are too few workers or productivity improvements or moderate inflation pressures. They begin not when the accommodative dynamics of the monetary stance ends but when the Fed stays excessively too tight for too long. At the time of writing, the policy rate was 75 bps below the Fed's estimated neutral rate, the yield curve (10-year minus 3-month yields) is far away from inversion, the credit spreads are steady and real rates are flat. Currently, the chance of having a recession is only 11%. The Atlanta Fed points to a 3.0% annual growth rate for Q/4 and the Cleveland Fed shows a 1.7% annual rate of core inflation for the December quarter.

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New Technical Perspectives as of November 8, 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 2641-2803 on Thursday morning, through key support.

2. Based on a proprietary model, the trend for Crude Oil is now neutral with key resistance at $70.99 and key support at $59.35-$61.79 on Thursday morning.

3. Based on another proprietary model, the trend for Gold is neutral with key resistance at $1269 and key support at $1181-$1224 on Thursday morning.

4. Based on a proprietary model, the trend for 10-year treasury yield is bullish with key resistance at 3.41% and key support at 3.03%-3.21% on Thursday morning.

5. Based on a Palos Currency Model, the trend for the Canadian dollar turning neutral with key resistance at 78.00 US cents and key support at 75.25 US cents-76.36 us cents on Thursday morning. New Purchasing Power Parity Rate is $79.50

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