Issue 10

PALOS
INVESTMENT FUNDS

March 8, 2018

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau & Evan Weiser

Pollard Banknotes Wins Big

There are over 200 lotteries that operate around the world that source their supply of lottery tickets from just a handful of companies. Pollard Banknotes (TSX:PBL), is one of three instant lottery ticket vendors in North America. PBL is growing significantly faster than its competitors and has been recognized by the industry for its "game changing" innovations. Pollard sells instant scratch tickets to 12 of the top 20 global lotteries and has 50 lotteries signed to long term contracts with renewal options. In 2017, PBL continued to improve its operations with the purchase of a new printing press that has had a positive impact on the company's margins and printing capacity.

Not content to rely solely on organic growth, Pollard has used its strong free cash flows to complete a string of acquisitions into growth segments of the gambling landscape. In Q3/17 PBL acquired INNOVA Gaming which manufactures "stay and play" instant ticket vending machines and electronic gambling terminals. In Q1/18, PBL announced the acquisition of International Gamco, a leading manufacturer of charitable gaming products and electronic gaming systems. The Gamco acquisition is complimentary to the INNOVA deal and is expected to double PBL's charitable gaming revenue establishing the company as the second largest supplier for charitable gaming organizations in North America.

Online lottery offerings represent another significant opportunity for Pollard, particularly in the US where most jurisdictions have yet to allow the sale of online lottery products. A joint venture with NeoGames to offer iLottery solutions is already beginning to show positive results. Pollard also has a significant advantage over its competitors in the space who derive most of their revenue from the sale of slot machines to casinos. The development of online gaming products places competitors in direct conflict with their largest customers, casino operators. Their inability to commit to the development of online products favours Pollard's iLottery offerings and might even force competitors into divestitures of their own iLottery business units.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.89	-2.33%
Palos Equity Income Fund - RRSP	PAL 101	$6.52	-2.30%
Palos Merchant Fund L.P. (Dec 29, 2017)	PAL 500	$4.61	15.26%
Palos WP Growth Fund - RRSP	PAL200	$9.86	-7.49%
S&P TSX Composite			-3.69%
S&P 500			2.84%
S&P TSX Venture			-2.22%

Chart 2: Market Data*

	Value
US Government 10-Year	2.86%
Canadian Government 10-Year	2.23%
Crude Oil Spot	US $60.33
Gold Spot	US $1,321.70
US Gov't10-Year/Moody BAA Corp. Spread	175 bps
USD/CAD Exchange Rate Spot	US $0.7754

* Period ending Mar 8, 2018

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■ What is New on the Macro Level?

By Hubert Marleau

International Trade Is Complex: What You See May Not Be What You Get

After making good on tax cuts and regulatory rollbacks, Trump introduces new tariffs raising fears of rising inflation and of damaging world trade. The injury to business sentiment is clear. The rebuke for his decision to levy tariffs on aluminum and steel imports is widespread domestically and internationally. The consensus opinion is running heavily against the President. It's not just about the rhetoric from businesses and conservative groups focusing on the potential cost of the tariffs. The prevailing assessment that the new tariffs are a tax on consumers and a net killer of jobs is doubtless correct. The magnitude is misleading. Mark Zandi at Moody's Analytic thinks that the action would affect only 190,000 jobs and about 0.1% in GDP growth. Steel imports totaled $30 billion in 2017 and aluminum imports totaled $17 billion. If one was to apply the planned 25% tax on steel and 10% tax on aluminum, the impact is $9 billion. This number is before one accounts for the resulting shift towards domestic production. The point is that the numbers are not large enough to cause much damage to a $20 trillion economy. In order words, it does not justify the $450 billion decline in the value of the stock market that took place between Thursday's open and Friday midday of last week. In many ways the tariffs are economically small. Symbolically however, they are huge.

President Trump believes that the U.S. is being duped in the global trade arena. On several occasions, he blamed America's trade deficits on the incompetence of past trade negotiators. Rather than explaining his position on trade in a rational way, he preferred the use of bombastic language. He has denounced China, called for the ripping apart of NAFTA, pulled out of the Trans-Pacific Partnership, put tariffs on solar panels, washing machines and Canadian lumber. Steel and aluminum are the latest to join the list.

In the words of former CIA director John Brennan, "President Trump is unstable, inept, inexperienced and unethical." Interestingly, Carl Icahn, ex-Trump special advisor, sold $31.3 million of Manitowoc shares on the 12th of February, days before the commerce department first announced plans to impose stiff tariffs on foreign steel imports. Given the avalanche of troubling headlines about top Trump aides, the Russian investigation, high-profile departures and widely criticized policy, it certainly looks as if there is a lack of leadership in the White House. Indeed, Trump overruled his pro-trade advisors in an impromptu manner by announcing a trade policy before any details had been worked out. Gary Cohn, head of the National Economic Council, National Security Advisor H.R. McMaster, Secretary of State Rex Tillerson and Secretary of Defense James Mattis and key congressional committee chairs were not consulted nor informed that Trump was about to announce tariffs. In his usual manner, he said: "trade wars are good" and "easy to win." On Tuesday last, Gary Cohn, a bulwark against protectionism, resigned. That tells me that President Trump is gung-ho about a trade war and disdains the laws and ethics that govern world commerce. Stephen Jen, the highly respected foreign exchange analyst who now runs Eurizon Capital in London put forward a far better argument. John Authers of The Financial Times summed up Jen's opinion very well.

"The US is the least protectionist large economy in the world, while China is the most protectionist. He pointed out that the US, based on data from the WTO, is by far the least protectionist nation in the world (with the exception of the tariff-free city of Hong-Kong and possibly Canada) - far more open than Europe, Japan and China. And it seems a bit hypocritical that more protectionist nations are complaining about the actions of the least protectionist nation."

"China has half of the world's steel production, much of which is excessive and unnecessary as even Beijing would admit. The 2008-09 huge industrial stimulus boosted China's industrial capacity, including steel. This has led to a situation where Chinese steel production had to be exported to the rest of the world at very low prices to keep the metal industry humming. Many consider this 'dumping'. Both the US, EU and Canada share the verdict that China is still not a "market-based' economy because of the large explicit and implicit government subsidies and other forms of support from the public sector, that make Chinese products unfairly competitive."

"Why is Europe not held to the same standard as the US? Europe is complaining about the US's latest policy. Investors should know that Europe has already imposed two dozen anti-dumping measures against Chinese steel exports. What is the substantive difference between the anti-dumping measures imposed by the EU and what Trump is doing? Is Europe less protectionist than the US? If Europe were so open, what is all the

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fuss about Brexit and the inability of the UK to access the European market?"

Being short on details, Trump appears to be just that a trade-war-monger looking for a fight. The American people and allies must wonder if Trump understand the fundamentals of the law of supply and demand, of national security and of international trade. Allow me to put forth short opinions on these three points.

1. In simple accounting terms, exports add to gross domestic product, while imports leave it unchanged. GDP represents all the stuff that gets produced in the country. Exports are produced domestically and shipped abroad in exchange for foreign IOUs, while imports are consumed domestically in exchange for American IOUs. If you close the trade deficit purely by reducing imports, while leaving exports, consumption, investment and government spending the same, the economy doesn't grow by even a dollar. But if you close the deficit by exporting more, while leaving everything else unchanged, the economy grows a lot. (Bloomberg) The is that trade imbalances are affected by numerous macroeconomic forces, including the relative exchange value of currencies, the relative growth rates of countries, relative inflation rates of countries and differences in their saving and investments rates. When it come to the current account of the balance of payment, one needs to include services. Overall, the U.S. has a goods deficit and a service surplus with the rest of the world. There is a lot more growth in the service sector of economy than in the physical sector.

2. One of the most basic concepts in economics is the relationship between supply and demand, and how that relationship determines the number of goods sold and at what price. The basic idea is intuitive: as the price of a good goes up, producers will be willing to supply more of the good, but consumers will demand less of the good. Markets are in equilibrium when the two groups match. The right amount of goods are sold at the right price so that production exactly matches consumption. Tariffs interfere with this equilibrium state. Taxing imports of goods increases the price of those goods for consumers, including other manufactures that use the items. Higher prices mean a smaller quantity of the product will be demanded, as described above.

3. National security is about preventing real threats to the survival of people and of a way of life. Representing Trump's tariff tantrum as a necessity makes him look like a buffoon. It is illogical to frame Canadian exports of metals to the U.S. as a national security risk. Islamic suicide bombers are stalking the free world, Russia is saber-rattling, Venezuela is smuggling Hezbollah terrorists into the Western Hemisphere, Iran is building nukes, and North Korea testing missiles are actual security threats. Yet, Mr. Trump says the Americans drinking beer out of cans made from Canadian metal is a national security risk. Winning a face-off form a weaker country is perhaps easy but it's what bullies are made of. Canada has a national pride and it will not indefinitely bow to American bullying. (WSJ)

Firstly, Mr. Trump believes that trade is a zero-sum game, with winning defined as having a national trade surplus. He thinks that when a country is down $100 billion in net trade with another country, you just don't trade anymore with that certain country and you win. U.S. international trade totals $5.4 trillion while the net difference between imports and exports is only $600 billion. The editorial board of the WSJ has a rebuke on Trump's thesis and it goes somewhat like this. The $600 billion deficit, albeit small in comparison to the overall economy, nevertheless represents an enormous amount of commercial activity, which creates jobs for millions of Americans. Imports create a multitude domestic activity. Input-output tables on economic activity would reveal that very fact. According to Trump, a trade-deficit remedy is to stop trade cold with a country. It assumes that somehow domestic production will rise and replace what is imported. Domestic production doesn't just happen overnight. He advocates what people in my profession calls autarky. That is economic self-sufficiency. History shows that the pursuit of autarky usually brings about economic contractions.

Secondly, autarky may open the door to blatantly throw out the international terms and rules and allow other countries to do likewise. What is misunderstood is that 95% of the worlds consumers are outside the US and many American companies, who get their livelihoods from selling goods and services abroad, depend on the goodwill of foreigners. Swift condemnation from trading partners is a major downside risk to the US economic outlook. Retaliation can be messy if the rest of the world goes down that road against the US. Beyond tariffs, countries have various tools including strategic strikes at certain industries, taking grievances to the WTO and voluntary boycotts.

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Thirdly, Trump invoked a trade law premised on protecting war-essential industries. Its plainly a pretext. The Department of Defense (DoD) intervention in the debate shredded the logic of protectionists. U.S. military requirements for steel and aluminum each represent about 3% of U.S. production. The DoD thinks that there is sufficient amount of domestic production of both steel and aluminum to meet national defense requirements. What did alarm the DoD, was the harm that steel tariffs could imposed on vital and indispensable alliances like Canada and South Korea. China does not rank among the top ten steel exporters to the U.S. In fact, the DoD pleaded for even more caution with regard to aluminum tariffs. Canada leads the list of aluminum exporters. Trump has damaged the U.S. led alliance system. The biggest source of steel imports shares a border with the U.S. The three countries are part of a single supply chain which tariffs would easily disrupt.

Fourthly, how can one possibly believe that other nations would not retaliate. China, Japan, Australia and the EU have already announced that they could take similar actions on jeans, bourbon and motorcycles targeting the home states of Republican leaders of the Senate and House of Representatives. All of this would weaken international trade conventions and the World Trade Organization (WTO) and introduce voluntary boycotts by foreign consumers on American goods and outlets abroad.

Fifthly, Trump has put forth the idea that lowering taxes and raising government expenditures works in tandem to reduce trade deficits. Put another way, Navarro, assistant to the President, believes that if the trade deficits go down, economic output must rise. This hypothesis can be falsified. It may not seem obvious, but the so-called twin deficits are derived from the same logic. Trump's fiscal policy will widen the federal budget deficit to 5.5% of N-GDP in 2019. This means that domestic quantitative demand will rise more than the economy can produce. It follows that the U.S. will direct the extra income toward imports pushing the current-account deficit to 4.0% of N-GDP in 2019. Furthermore, this is happening at time when businesses intend to increase capital investments far above their cash flows. Consequently, one can be sure that there will not be sufficient domestic savings to meet domestic investment. In other words, there will be an increased demand for foreign capital to fund the saving deficit. The U.S. is dependent upon foreign capital in a way the president abhors when it comes to steel and aluminum. Either real interest rates (the nominal interest rate less the rate of inflation) will have to be set higher and/or the dollar will need to be set at a lower value. Currently, the federal debt totals 100% of N-GDP and foreign liabilities total 40% of N-GDP. It isn't just how much the U.S. owes, it's also to whom it owes. China has $1.2 trillion worth of U.S. treasury securities. That is almost 20% of foreign holdings. It should be noted that China, which has been the object of the administration's ire on trade, is considering halting its purchases of treasuries and paring them down. Recently, the U.S. has not relied on foreign buyers for treasuries because the bull market in stocks was the attraction. This may change. China ranks high on the punitive list.

Lastly, there is no evidence that either the steel or aluminum industries have enough extra capacity to replace current imports. U.S. production of these two metals has not increased since the mid 1980s; not for a lack of demand but for a lack of capacity. It is rumoured in the media that steel and aluminum makers are about to restart old mills that have been shut-down for years and are probably inefficient to boost capacity and quickly make up for imports that face being priced out of the U.S. market. Millions will be wasted in two uncompetitive industries to possibly save a few seats in the legislature.

Therefore, the economics of the tariff decision are curious and appear irrational. Tariffs are a bad and inefficient way to help small minorities. Moreover, tariffs could obstruct the bullish economic atmosphere. Business investment depends on predictable policy and relentless chaos can take its toll even on cooler heads. The administration is imposing protectionist tariffs on a manufacturing sector that is doing very well. Last week, the Institute for Supply Management (ISM) reported that its manufacturing gauge hit a new high of 60.8 for this cycle in February. Anything above the 50 mark denotes expansion. The users of steel will be disadvantages by the potential rise in steel prices and potential retaliation. Payrolls of steel and aluminum producers totaled 200,000 compared to 6.5 million in industries that use the metals.

The Bottom Line

There is in the end only three possible reasons for such a shocking decision. For Trump, there is no middle ground for trade making it the central policy fault line. Either Trump knows little about economics and what works over the long-term, or is governed by the prevailing mood of his constituency, or willing to take a very big gamble

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that his actions will bring fair trade advantages to the U.S.. Interestingly, several liberal think tanks believe the tariffs could actually help global markets. They argue that tariffs would punish countries that overproduce and bring stability and certainty to producers of steel and aluminum in the U.S. And, there are a few political thinkers who believe that Mr. Trump is an outsider that likes dealing in disruption and a showman that just wants a spectacle with him at the center leaving others to close the Pandora's box. Robert Lighthizer, White House trade guru, will quickly pare back in one-on-one negotiations with countries or companies with specific exemptions on certain products leaving, in the end, the tariffs only on Chinese metals. Meetings with China and top U.S. officials (Cohn, Mnuchin, Lighthizer) were held a few days ago to discuss ways to achieve balance and reciprocity. Bloomberg calls it right when it says that the president is a wild card. For instance, his administration is full of anti-Putin hard-liners even as he craves rapprochement and full of globalists (except Navarro and Ross) even as he craves protectionism.

Goldman Sachs delivered a comprehensive critique of Donald Trump's planned metal tariffs, saying "they risk damaging the world's biggest economy by raising costs as price pressures build, hurting allies more than others, and creating a two-tiered global market." The report adds that "by imposing across-the-board tariffs to all steel and aluminum imports, the larger impact is on Canada, Mexico and the EU, and it ironically eases the economic impact to China and Russia." The Goldman analysts led by Jeff Currie wrote that "economically, a two-tier metal market is ultimately damaging to U.S. downstream industries that consume these metals, as it creates an uneven playing field for U.S. industries that face higher metal prices." It is odd that Trump is willing to risk a trade war with countries that would likely be glad to form a coalition against China's predatory trade practices.

On Canada and NAFTA

Canada has the most to lose on the metal tariffs and faces the most imminent risk from an escalation. A trade war would be devastating. Not surprisingly, the exchange value of the Loonie has given back all the gains registered in the past year and now trades below its purchasing power parity rate of $0.78. A U.S. decision to withdraw from NAFTA would make things worse. In my judgement, Canada and Mexico will have little choice other than to acquiesce. Bargaining with someone who has a large gun and is willing to use it is not what I would call a fair fight. That is why in the mind of Trump, it's easy. Canadians should not expect to come out of this one with a win. Steel and aluminum are big deals in Canada. Using tariffs as an incentive to have the NAFTA negotiations on a fast track to get a reworked in the image of Trump is a foregone conclusion. Game theory is revealing in how relations between countries works. In order for everyone to win there must be cooperation for without it there can only be one winner. I feel a bit better. Canada and Mexico are exempt from the tariffs if a deal is made on NAFTA. A relief!

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