Issue 16

PALOS
INVESTMENT FUNDS

April 19, 2018

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Stelco Strong as Steel

We have recently taken a liking to Stelco holdings (TSX: STLC), a producer of value-added steel products with headquarters in Hamilton, Ontario. Stelco is an impressive turnaround story that has successfully emerged from bankruptcy. The company now has a strong capital structure with no long-term debt and over $250 million of cash on hand as at December 31, 2017. STLC also has no pension liabilities, low input costs and has a dividend yield of about 1.70%. Stelco produces steel products using new metals whereas many in the industry use scrap metals. With the increasing prices of scrap metal and synthetic graphite rods, Stelco is well-positioned to compete on price.

The company's management team has a clear vision to maximize shareholder returns while maintaining a strong balance sheet. They are refurbishing current assets and optimizing their production while focusing on products and end-markets with the highest potential for profitability and growth. The management team also has a proven track record of value creation through disciplined M&A which they plan on leveraging to find new opportunities.

We recently got to meet the team and we really liked what we heard. We believe they are taking the right steps and that the company is in great hands. We believe that the stock was oversold throughout the month of March due to the steel tariffs implemented by the Trump administration. However, as Canada is currently excluded from the tariffs, Stelco is unaffected.

STLC is quite inexpensive when compared to its North American peers. When looking at 2019E EV/EBITDA, Stelco trades at 4.0X while its peers trade at 6.0x.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.70	-2.23%
Palos Equity Income Fund - RRSP	PAL 101	$6.42	-2.46%
Palos Merchant Fund L.P. (Dec 29, 2017)	PAL 500	$4.61	15.26%
Palos WP Growth Fund - RRSP	PAL200	$9.61	-10.19%
S&P TSX Composite			-3.86%
S&P 500			1.30%
S&P TSX Venture			-5.66%

Chart 2: Market Data*

	Value
US Government 10-Year	2.91%
Canadian Government 10-Year	2.32%
Crude Oil Spot	US $68.15
Gold Spot	US $1,347.10
US Gov't10-Year/Moody BAA Corp. Spread	176 bps
USD/CAD Exchange Rate Spot	US $0.7892

* Period ending Apr 19, 2018

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■ What is New on the Macro Level?

By Hubert Marleau

Will NAFTA be Saved?

According to Moises Kalach, a Mexican trade director for the national business chamber, work on a revamped NAFTA agreement is ready to close nine of the ten chapters focused on modernization. These chapters include telecommunications, energy and the environment. There are five demands that are unacceptable for Mexico: the sunset clause, the seasonality to limit exports of fresh products, settlements of trade dispute, access to U.S. procurement deals and the termination of NAFTA after five years. Additionally, the U.S. has yet to present a proposal for automotive content rules that would be vital to the industry and acceptable to all parties. On the crucial auto issue, Canada appears to be cautiously optimistic while Mexico says that important changes need to be made to achieve a resolution.

It is our understanding that the U.S. has softened their demands in the auto sector. Under the current NAFTA deal, 62.5% of all car parts must be sourced from the three countries to qualify for tariff exemptions. The U.S. negotiators are proposing a 75% content criterion, down from their initial position of 85%. The Canadian team appears optimistic as they believe that a lot of progress has been made on border-adjustment tax, the role of artificial intelligence, and the value of R&D. Moreover, U.S.-specific content requirement are out. Canada has pointed out that the negotiators for an auto agreement should be careful on making changes by adding rules that could raise costs and potentially undermine the ability to compete in the future. For example, valuable electronic systems are largely made in Asia. Rebuilding a manufacturing base in North America would not be a simple matter. The U.S. levies only a 2.5% tariff on cars imported from elsewhere. At some point companies may judge that it would be better to fabricate cars totally in China.

Last week in Peru, the Mexican Economy Minister Ildefonso Guajardo said that "he sees an 80% chance of an initial agreement by the first week of May." The prediction makes sense as the Mexican peso is up 8% against the dollar since the start of the year. This is particularly good for a country whose economic lifeline is threatened by Andres Manuel Lopez Obrador, a populist leftist and Donald Trump, a populist on the right. The forex markets advance rests on trading experts' growing conviction that NAFTA will be settled. It should be noted that the real grudge is with China which accounts for 50% of U.S. trade deficits compared to just 10% for Mexico.

The bottom line is that Trump administration officials are eager to conclude negotiations quickly, perhaps as soon as the first week of May. With trade disputes erupting on multiple fronts with China, the U.S. is probably feeling the pressure to get a NAFTA deal done and explore other bilateral venues. The U.S. must first secure a deal showing a willingness to trade. To meet all of the necessary deadlines, Trump needs a revised NAFTA agreement approved by the Republican-controlled Congress. Many trade advisers fear that if the Democrats were to retake the House in November's midterm elections, congressional approval of a Trump-NAFTA deal could prove difficult as many democrats oppose NAFTA. To ensure full Republican support, Ted Cruz of Texas, Steve Daines of Montana and Cory Gardner of Colorado have urged President Trump to use the renegotiation of NAFTA to reduce domestic regulation and enhance competitiveness. Such a chapter (Regulations from the Executive in Need of Security Act or Reins Act) could be included as an annex that would be applicable only to the U.S., so that neither Mexico or Canada would need to agree. It would be a deregulation win that requires only 50 votes in the Senate. Such provisions would make NAFTA and other trade agreements more attractive to wavering Republicans, free-traders, and protectionists alike. There is a growing consensus among conservatives to adopt such an annex judging by the many groups that are racing to support the Cruz-Daines-Gardner strategy such as Americans for Tax Reforms, the Competitive Enterprise Institute, the Club for Growth, and the Independent Women Forum. As many as 30 organizations endorsed the idea of a NAFTA competitiveness chapter, arguing that it would strengthen the core objectives of the NAFTA renegotiations by making it more attractive for companies to invest and create jobs. This would help the republicans motivate their base in the midterm elections if they were to go along with a NAFTA deal.

Have Oil Prices Peaked?

The price of crude oil recently reached its highest level since 2014. On Thursday, the spot price was $67.50. The technical team at CitiFX thinks that the current rally is off from the lows of 2016,

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looks very similar to the path of the 2009 to 2011 price recovery. Oil prices peaked at $115 in 2011. A similar dynamic this time would suggest a $60-$70 range after an $80 high is put in. There is a view that Saudi Arabia is targeting oil prices at $80 a barrel to boost the valuation of Aramco ahead of a forthcoming IPO in 2019 and to finance increasingly ambitious policy plans. Saudi Energy Minister Khalid al-Falih has also signaled that the kingdom would rather overtighten the market instead of leaving the job of erasing the glut undone. In any case, stored oil is at its lowest level in more than three years, due mainly to OPEC and Russia's output cuts and partly due to humming global demand and several supply disruptions. Data released by OPEC shows that there is only a surplus of 43 million barrels, based on the latest five-year averages. Two years ago, the storage surplus was 400 million barrels. It shows that the rebalancing process is well under way. In fact, a few supply outages could quickly drain inventories and even create a shortage. The cushion is gone and geopolitical risk (Iran, Syria, and Russia) is bubbling up in the oil pits. Despite an approaching balanced position, Saudi Arabia has indicated little appetite for opening the spigots saying that it would keep its overall crude-oil exports below 7 million barrels a day. The Saudis are assuring everybody not to let another oil glut resurface in the coming years. Nevertheless, OPEC admits that increased amounts of North American oil will be pumped in 2018 reflecting higher oil prices. It's pretty conclusive that a surge in oil price is improbable other than a temporary one for energy alternatives are available and N.A. has essentially replaced the Middle East as the oil swing producer. The sweet spot is $65 a barrel for West Texas intermediate.

On Inflation: The Fed's Inflation Target Reached

Minutes from last month's policy meeting shows that the monetary authorities have increasing confidence in their views that inflation has reached its target. Recent data supports their confidence. The Labor Department on Wednesday last reported that core consumer prices, which exclude food and energy to better capture inflation trends, were up 2.1% on the year. Based on preliminary data, the Personal Consumption Expenditure Price Index, the preferred set of data of the Fed, should show a 2.1% yearly increase on April 30. Indications from the various regional Feds suggest that they are willing to let inflation run a bit above 2.0% for a short while in order to push long term inflation expectations higher, limiting the risk of inflation running too cold. The Fed wants to get across that it is just as ok for inflation to be a bit above the target as it is to be a bit below. The big risk is that the tax-cut and the spending stimulus currently coursing through an economy with little labour slack will get the Fed worried if inflation rate goes too far above its target.

At this point in time, we are not ready to give in to the idea that future average hourly earnings gains will bring about a wage spiral. We agree that wage growth is set to pick up in the coming years but only moderately because powerful forces like globalization, hidden slack, deregulations, sluggish productivity, aging population, technology and competition from overseas will partially offset the inflationary effect of low employment. Private forecasters surveyed by the WSJ on average predicted 3% earnings growth in 2018 followed by gains of 3.2% in 2019 and 3.1% in 2020. While these forecasts exceed the 2.7% pace of recent years, they would still be historically modest gains given that the unemployment rate is expected to fall below 4.0% by the end of this year. A recent study shows that the natural rate of employment has shifted down to perhaps as low as 3.0% because there has been a very big rise in the number of workers who want to work more hours while there has been little change in the number of hours of workers who want fewer hours. Underemployment reduces wage pressure. Moreover, a series of downbeat business surveys, plus moderating growth in retail sales and decelerating employment growth and reduced bank credit growth are changing the economic outlook. The Citigroup economic surprise indicator, which measures actual data relative to predictions, has turned sharply downwards. The Atlanta Fed's GDPNow model estimate for real GDP growth in the first quarter of 2018 is 2.0 %, down from 5.5% at the end of January.

It may not be premature to call the top of the recovery in growth terms. A reduction in the excess reserves of depository institutions and a noticeable slowing in the rate of growth in the money supply have occurred. Consequently, it may become much harder for credit creation to fill the widening gap between N-GDP and National Income given the expected increase in the cost of money and the high level of private debt to GDP. Currently, the level of private debt is 150% of GDP, a natural barrier where the private sector tends not to take on more debt. In the quarter ended December 2017, the gap totaled $2.9 trillion compared to $2.4 trillion in 2015. Accordingly, we are sticking with our previous

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observation that the U.S. economic boom is fragile and forecast that growth is cresting. In our judgement, we will soon return to a two-plus-two economy, two percent inflation and two percent growth. The Cleveland Fed Inflation Nowcasting model is presently predicting 2.0% inflation for the second quarter of 2018. Even if it is tempting to jump the gun that on inflation, it still is unlikely that the deflationary environment has come to end. Recent pricing pressures are cyclical rather than structural. We think that there is a possibility of stronger-than-currently-anticipated reversal of reflationary momentum. Mounting empirical evidence shows that debt, like other factors, is subject to the laws of diminishing returns. It now takes a lot more debt to produce $1.00 of economic activity than it five, ten, or twenty years ago.

Is the Stock Market Correction Over?

It should be noted that the recent weakening in economic activity should not be interpreted as a negative; it's putting the economy back into a sweet spot. The stock market has done very since the Great Recession with a two-plus-two economy. As long as the probability of a recession remains low as it currently is, a two-plus-two economy can do wonders for both the stock and bond markets. Under such a two-plus-two scenario, recession risk stays low because it means that consumers are relatively thrifty, housing prices are not excessive, and businesses aren't over-invested in fixed assets. Should our prognosis hold, yields on ten-year U.S. Treasuries should not go any higher than 3.10% giving enough juice to produce a reasonable rate of return for stockholders. The treasury market is largely trading off growth and not inflation expectations. Therefore, a return to a non-inflationary two-plus-two economy would probably limit the Fed's monetary stance. Robert Kaplan, president of the Dallas Fed has already come out with the opinion that he would not be in favour of moving the federal funds rate above the neutral rate of 2.625%. In this regard, we may be close to the flattest yield curve of this recovery. Nevertheless, using Kaplan's neutral rate we are only in the middle decile of monetary history. According to Jim Paulsen of Leuthold Group, it means that the probability of a recession is only 4.1% yet the treasury market has already begun pricing rate cuts by the end of 2020. This leads us to believe that we are going back to the 2009-2017 two-plus-two economic regime and that the Fed will hike rates a little more near term, but will stop pretty soon. In turn, interest rates may not push the discount rate too far out to negatively affect valuations.

If 2009-2017 stock market history is a reliable base, a two-plus-two economy should be good enough to assure 2018 and 2019 S&P 500 EPS expectations of $155 and $170 respectively. Moreover, companies are holding on to a ton of cash and equivalents that could end up in shareholders' hands. S&P 500 companies, excluding financials, had $2.4 trillion of cash and cash equivalents at the end of 2017 compared $2.2 trillion at the end of 2016 and $1.6 trillion in 2009. This is a 50% increase. If one was to factor in this cash (excluding the 2018 tax windfall) in the stock price, the forward P/E multiple would be a lot less than the present 17.0X. The P/E would be closer to 14.5X. The current 280 bps gap between stock earnings yields (5.90%) and our projected bond yield (3.10%) would be significantly less if one would use the cash adjusted P/E of 14.5X. The yield-gap would be 380 bps. I can see why JPM projects that buybacks will total $800 billion in 2018 versus $525 billion in 2017. Buybacks could therefore once again underpin the stock market at a time when tension are running high over geopolitical risks, a spring slowdown in growth, rising inflation and possible technology regulations. According to Bank of America Merrill Lynch's latest monthly fund-manager survey, the cash holdings have increased to 5% from 4.6% in March. The same survey found that only 13% of respondents see a recession as likely, while only 18% think the nine-year bull market has peaked. There is no true bull market capitulation. As a rule, fund managers insist that they don't have a favorable alternative when it comes to investing in bonds over stocks. Ten-year Treasury yields would have to settle around 3.5% before such a strategy would be put in place.

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