Issue 17

PALOS

April 26, 2018

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Transcontinental is Transforming

In the past, Transcontinental Inc. (TSX: TCL/A) was known as Canada's largest printing company. For many years, the company faced falling demand for printed products. We all know that the physical newspaper business is declining and will probably disappear in the coming years. TCL/A has navigated this decline as efficiently as possible. For example, printing revenue has been falling for the last decade, but the company was able to keep its margins stable, and its EBITDA has also declined less than its revenue on a percentage basis. This was achieved by having a disciplined management team, that acted by closing inefficient printing presses, and selling non-core media assets. Its discipline allowed the company to shore up its balance sheet and make a few small acquisitions in packaging. However, none of them where large enough to transform the company until they announced the US$1.32 billion Coveris Americas acquisition on April 02, 2017.

The acquisition will transform TCL/A into a long-term sustainable business model. The packaging division will represent 48% of revenues and 37% of EBITDA. The company will no longer be facing declining revenue or EBITDA. Palos is also of the opinion that packaging has favorable macro tailwinds as consumers' behavior continues to change to online shopping. The acquisition purchase price may seem a bit high at 10.3x EBITDA, however this does not consider synergies. Management believes that with cost savings and synergies of USD $20M they paid closer to 8.9x. The acquisitions also provides the company with a strong competitive position in packaging.

To make this acquisition possible, the company raised $275 million, used its cash on hand, and issued debt. Upon completion, the company's debt/EBITDA will rise to 2.54x, which we believe is very manageable. Furthermore, management stated that they are confident that its debt/EBITDA will decline to 1.35x within the next 24 months.

Palos is very confident that management will be able to execute on this opportunity. The team has been well groomed and has significant experience optimizing efficiency. They had no choice but to

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.76	-1.59%
Palos Equity Income Fund - RRSP	PAL 101	$6.45	-1.94%
Palos Merchant Fund L.P. (Dec 29, 2017)	PAL 500	$4.61	15.26%
Palos WP Growth Fund - RRSP	PAL200	$9.58	-10.45%
S&P TSX Composite			-2.65%
S&P 500			0.32%
S&P TSX Venture			-7.90%

Chart 2: Market Data*

	Value
US Government 10-Year	2.98%
Canadian Government 10-Year	2.35%
Crude Oil Spot	US $68.22
Gold Spot	US $1,316.30
US Gov't10-Year/Moody BAA Corp. Spread	180 bps
USD/CAD Exchange Rate Spot	US $0.7766

* Period ending Apr 26, 2018

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learn this skill set as they have been faced with printing macro headwinds for decades. Palos has the utmost confidence in TCL/A's management team and in their ability to execute on their plan.

■ Mendel's Option Corner

By Robert Mendel

The other day while driving I passed a Tesla car dealership. It got me thinking of the wild price swings of TSLA stock. These days, it seems as if wild price swings can affect most stocks. While it is hard enough to pick winners over a longer time period, it is surely next to impossible to pick them in the shorter run. That's why I need an edge. My edge is the various options strategies that I use to tilt the 'odds' in my favor. I guess my high school math classes came in handy after all.

Welcome to the first edition of the Options Corner. Assuming the powers that be here at Palos like it I will continue to bring different option ideas forward. Hopefully you will find it informative.

Ask many people about options and the immediate thought is 'hey that's not for me' But what if I said options can be used effectively to reduce volatility and risk. And there are many ways to do that.

Let's start with the backbone of the Canadian stock market and the biggest company of them all, Royal Bank (TSX:RY). RY has pulled back enough to make it interesting for me to commit more money to the name, yet at the same time I am uncertain of the short-term direction of both the market and the stock. So, here is what could be done:

Buy RY at $97 and immediately sell the Oct 105 calls for $1.00 for a net cost of $96. I collect the dividend of .94 cents which equates to 3.87% plus have all the upside participation until $105 at which point I have entered into an agreement to sell the stock. In this market I am ok with this trade-off and am happy to cap my upside in exchange for a little more downside protection. Selling the call will generate an additional 1% in roughly 6 months (178 days, it expires Oct 19) which is 2% annualized. This is on top of the dividend and any capital appreciation that may arise. That's pretty good. If the shares trade flat I am still ahead and if they fall I lose less.

The above strategy is a bullish call strategy where you think the stock will continue to grind higher. But if you want to be more conservative you can also sell a call at a lower strike price which would give you more downside protection but would come with a lower return as well. The fascinating thing is that there are no right or wrong answers. It all depends on someone's individual outlook.

If you found this interesting stay tuned there will be more to come where we will look at all sorts of other scenarios. Thanks for stopping in!

■ What is New on the Macro Level?

By Hubert Marleau

The Canadian Dollar

Even with an acceptable NAFTA deal and sustainable oil prices around $65 a barrel, the Canadian dollar should, nevertheless, trade below our estimated Purchasing Power Parity Rate (PPPR). Our revised calculation puts the PPPR at 79.5 us cents. On April 18, Governor Poloz decide to keep interest rates on hold reflecting his comfort with recent economic data. He defied expectations of a rate hike to mimic the Fed's earlier decision to raise the federal funds rate to 1.75%. The decision unsettled forex traders. The exchange value of the Canadian dollar dropped from $0.7975 to $0.7750 in a matter of days. On Thursday, the Loonie was trading for $0.7772.

From here on, the performance of the Loonie will be dependent on how the Bank of Canada will conduct its monetary stance. In turn, this stance will be dictated by the evolution of specific data points and today's starting point. The Palos Monetary Policy Index, which takes into account factors like price stability, viability of the balance of payments, economic growth and employment plus the inflation content of the misery index clearly suggests that the Canadian monetary authorities ought to tilt their monetary posture toward some tightening. Presently, the Palos Monetary Policy Index stands at 117, above the inflection point of 100 and the inflation content of the misery index is above the crucial crossing point of 25%. Interestingly, the median of forecasts compiled by Bloomberg is 80 cents USD by year end signifying that traders are betting that at some point in time the central bank is going to muscle in and bringing back rate hikes. This means that forex speculators believe any uptick in economic activity from the soft patch registered in last six months would likely stiffen the central bank's monetary stance. It may look like a good bet as headline consumer price inflation in March accelerated to its fastest pace since October 2014 for an increase of 2.3% on the year. However, the Bank is ambiguous on this inflation point. On the

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one hand, the central bank judges that transitory effects related to energy prices and minimum wage hikes caused the recent acceleration in inflation. On the other hand, the bank elevated its inflation forecast, raising the year-over-year change in CPI from 1.7% to 2.1%. For the whole of 2018, the bank expects inflation of 2.3%, compared to 2.0% in January.

Governor Poloz is optimistic that the economy will turn around for the better without generating more inflation. The latest monetary report notes that three-quarters of all industries have a capacity utilization rate within 5% points of their post-2003 peak. Industrial capacity utilization hit a 10-year high in the fourth quarter of 2017at 86% compared to the all-time high of 87%. Poloz is making a wager that the lack of industrial slack combined with an encouraging business outlook survey that sales expectations are firming up will prompt businesses to invest in productivity enhancement equipment. In this regard, the Bank of Canada is hopeful that the rate of economic expansion, which will likely register only a 1.3% annual rate of increase in the first quarter of 2018, will rise to 1.8% over the next two years. The central bank made a substantial upgrade from its January review when the potential growth was believed to be only 1.4% in 2018 and 1.5% in 2019. It's a big gamble as Canadian business may opt to put their investible money into the U.S. where corporate taxes are lower, where the U.S. dollar is cheap worldwide and where cheap energy is readily available. Canadian corporate investment intentions are not overwhelming. Moreover, household spending is showing early symptoms of fatigue. Retail sales in February excluding automobiles were basically flat. Additionally, the Canadian housing bubble continues to deflate. Notably, both the RPS House Price Index and Statistics Canada new house Price Index indicate a downward trend. According to the Canada Mortgage and Housing Corporation's housing report, high household debt, rising interest rates and new regulations on mortgage financing could bring about a housing surplus that can only be cleared with lower prices. Because there has a been a deluge of data that generally underperformed consensus expectations, we are not as optimistic as the central bank projects. In the six last months, the Canadian economy grew at the annual pace of 1.5% while the pace of inflation was right on the 2% targets and core inflation measures trended upwards. This tells me that we are operating at full capacity and that anything above 1.5% growth can only generate more inflation than what is considered appropriate. Accordingly, the Bank of Canada should feel the pressure to raise rates. Despite these indication, there's only a 33% chance of a May increase.

In its latest communique, Governor Poloz create a narrative to excuse himself from raising the benchmark to 1.50%, even though he should have. His argument is that the economy is not able to remain at full capacity on its own. In other words, the Governing Council is willing to keep interest rates below the 2.00% neutral level and keep real rates negative. This kind of thinking may lead to a policy mistake. It should be noted that the bank still believes that the neutral rate is 3.00%. That makes matters even worse. Keeping real interest rates very negative and nominal rates way below neutral, when an economy is operating at full capacity does not bode well for the Loonie. We see no reasons why the Loonie should trade above its PPPR. Currently, the gap between U.S. and Canadian benchmark rates is 0.625%. At this point in time, only one or two more rate hikes are expected in Canada while three or four hikes are expected in the U.S. According to our way of thinking, the exchange rates usually absorb the brunt of policy mistakes. History is not kind to currencies whose central banks apply easier money than they should. Sleeping beside a Giant makes it difficult to have an independent monetary policy. Canada needs do better. This means lower corporate taxes, more pipelines, productivity enhancement projects, and the modernization of old infrastructure.

Outlook: The U.S Bond Market

The bond markets primary benchmark, ten-year treasuries, are settling for 3.00% and yields are up 0.60% since the end of December 2017 in response to the prospects of higher inflation and stronger economic growth. Chances are slim that the U.S. is about to enter a recession anytime soon. Interestingly, inflation expectations account for only 20 bps of the yield increase and while 40 bps is related to prospective growth and term risk premium. High frequency models indicate that the economy is in the process of returning to a two-plus-two economic regime. Two percent inflation and two percent growth. If the historical relationship between long term bond yields and N-GDP growth were to hold, ten-year treasury yields will probably be range bound from 2.75% to 3.25%. Moreover, the Fed, from hereon out, will become increasingly sensitive to the shape of the yield curve and the gap between the neutral rate (2.75%) and federal funds rate (1.75%).

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Over the Next Few Days

By the end of next of week, we will know if we are right about our forecast that we have a return to a two-plus-two U.S. economy.

1. On April 27, the BEA will report GDP data for the first quarter of 2018 and the Employment Cost Index. Atlanta Fed's High frequency model shows 2.0%, real growth and that is right on our forecast.

2. On April 30, the Personal Consumption Expenditures, the Fed's preferred inflation gauge, will be released. The march report is expected to come in right on the Fed's 2.0% target.

3. On May 1, the Institute for Supply Management will indicate how the Trump administration's tariffs affected business activity and the outlook for corporate pricing power.

4. On May 2, the treasury will announce its refunding needs which will map out how the government plan to fund a rising budget deficit

5. On May 4, the BLS will give us the April employment situation. It will take at least 110,000 net new jobs to keep the unemployment rate at 4.1% and about 200,000 to keep economic growth near 2.0%., if there is no change in the labour participation rate. The big number to watch will the average hourly earnings, which came in at 2.7% in March.

Technical Perspectives of the Sevens Report (April 26, 2018)

1. The broad uptrend trade of S&P 500 remains intact. Short term range—2569 to 2816

2. Oil futures are decidedly in a bullish trend. Short Term range—$63.73 to $73.43

3. Gold prices are trendless and future movements are expected to remain sideways. Short term range—-$1278 to $1405

4. Yield on Ten-year U.S. treasury is decidedly bullish. Short term trend— 2.720% to 3.154%.

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