Issue 19

Palos Weekly Commentary

May 10, 2018

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■ Palos Funds

By Charles Marleau

Turning Wind into Cash Flow

Northland Power Inc (TSX:NPI) reported a strong first quarter that beat consensus estimates. NPI reported an Adjusted EBITDA of C$290M and consensus was at C$257M. The beat came from better results from the offshore assets and lower expense. Furthermore, the company is also off to a great start in 2018. NPI won the contract for an offshore wind project in Taiwan (300MW), and the construction of the Deutsche Bucht offshore wind project continues to be on schedule and under budget. Palos believes that the market is overlooking NPI strong performance because of interest rate fear. However, NPI continues to deliver strong results, and has become a free cash flow (FCF) machine. The adjusted FCF/share for Q1 was $0.85 well above the streets estimates.

Palos continues to see NPI as one of our favorite utility stocks in Canada, as it has great growth visibility and management has proven themselves time after time.

■ Mendel's Option Corner

By Robert Mendel

Stock reactions to earnings are always fun to watch.

Moves of more than 5% are not uncommon and with the introduction of weekly options money can be made or lost. And quickly. The attraction to quick gains is inherent in all of us.

Take Amazon for example. It was reporting on Thursday April 26 after the market close.

What did I do? Feeling optimistic and breaking with my norm of selling premiums and with the stock at $1515, I bought the April 27 1600 call option for $8.50 right before the market close. What does this mean? I was simply betting that the stock would move higher. But because of the big premium I was paying I needed AMZN to move up 6% just to break even ($1600 +$8.50 = $1608.50 -$1515 = $93.50/$1515)

The odds were against me, but I was in that mood. Sure enough the earnings report was released and they blew away numbers. The stock shot up after hours to over $1635 which translated into a $35

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.96	0.42%
Palos Equity Income Fund - RRSP	PAL 101	$6.57	-0.18%
Palos Merchant Fund L.P. (Dec 29, 2017)	PAL 500	$4.61	15.26%
Palos WP Growth Fund - RRSP	PAL200	$9.51	-11.15%
S&P TSX Composite			-0.59%
S&P 500			2.51%
S&P TSX Venture			-8.87%

Chart 2: Market Data*

	Value
US Government 10-Year	2.96%
Canadian Government 10-Year	2.40%
Crude Oil Spot	US $71.36
Gold Spot	US $1,320.50
US Gov't10-Year/Moody BAA Corp. Spread	186 bps
USD/CAD Exchange Rate Spot	US $0.7833

* Period ending May 10, 2018

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call option – not bad considering I paid $8.50. Nice! I thought. Trouble is I couldn't sell it (options don't trade after hours) and had to wait until the next morning. Fortunately for me, the next morning saw the stock open at $1,634 and I was able to sell my little casino ticket for $32 (don't know about you but I could never get the high and couldn't get $35) The stock then came back down a little bit and traded below $1600 closing at $1,572 for the day.

Had I not reacted as fast as I did, all would have been lost since the option had no real value under $1,600. And that is the key. When buying an option time works against you not for you. So if you get the move you want don't be a pig, take your gain. There's always another trade, especially when time is against you.

■ What is New on the Macro Level?

By Hubert Marleau

The Stock Market

The bull market in U.S. equities, which began on March 9, 2009 and the excess equity returns above risk-free bonds have been outstanding. During the period under review, the S&P 500 registered a total return of about 500% compared to a total return on a ten-year Treasury note of 35%. For the record, increasing stock prices accounted for nearly 400% of the total return while dividends contributed the rest. We do not expect a repeat of this extraordinary performance. However, we are positive that prospective stock market returns will be respectable.

We disagree with the notion that stock market valuations have gotten so much ahead of the economy and that the uptrend is too old and too tired for businesses to provide respectable equity returns over the coming years. The bears believe that R-GDP growth numbers (which has been anemic averaging only 2.2% growth over the last ten years) are unsupportive of the decade-long bull run. They argue that there have been eleven economic expansions in the post WWII era and these have collectively averaged 4.5% R-GDP growth, much more than what has been the recent experience. The comparison makes them believe that the aggregate market-cap of the S&P 500 to N-GDP ratio is extreme. This big picture barometer, N-GDP to S&P 500 ratio, is currently 7500 times. The last time this ratio was that high was in 2000 when long term interest rates were 6.50% compared to 3.00% today. If one was to adjust for the difference in interest rates between now and then, one would cut the ratio in half just to be comparable and fair. It should be noted that N-GDP only tracks final sales and not total economic activity. Gross output which includes business-to-business activity was $34.5 trillion in Q4/17, nearly double the $19.7 trillion reading for N-GDP. Therefore, we don't think that stock market capitalization to N-GDP, necessarily signals over-valuation.

What the bears omit is that the environment for large businesses has been great, resulting in declining input costs, low wage pressures, low interest rates, consistent stability, reduced corporate taxes and digital efficiencies. What the perma-bears are missing is that equity-capital has been rewarded with far more earnings than other forms of income. Since the December quarter of 2008 to the first quarter of 2018, after tax corporate profits increased 300%. When one correctly calculates the arithmetic of what happen since the end of the great recession, one would conclude that the big picture barometer is nowhere near the extreme levels that some profess. In fact, there is still room for the U.S. stock market to go up in terms of market-cap-to N-GDP ratio. The big question is whether the investment landscape has changed enough to obstruct what we have been used to, moderate but stable growth.

U.S. stocks appear deadlocked despite blockbuster earnings. On average, earnings per share are topping analysts profit expectations and are about 25% higher than a year ago. Questions about the durability of global growth, the tightening of monetary policy, the creeping inflation, peak earnings and market volatility have left investors is a rut, neither inspired to inject new money into the stock market nor convinced that they should bail out. Investors are in a holding pattern for they cannot make up mind one way or another. They hesitate to commit. It explains why the stock market has withered in a narrow range---staying above but near its 200-day moving average without breaking out to new highs or slumping to new lows. It's as if the market is waiting for signals that will disprove the aforementioned concerns and waiting for signs that will prove the bears wrong and/or catalysts that could break the lull. For one thing, valuations are not bad as the S&P 500 is trading at 16 times 2018 expected earnings per share in line with the last five year average of 16.1 but somewhat above 10-year average of 14.3. Based on 2019 expectations, it's relatively cheap at 15.2 times. Accordingly, the reality is that the stock market is forward-looking. Profit increases combined with an even keel monetary stance, relatively low bond yields and stable inflation paint a favourable

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picture. Several reasons support the belief that the U.S. stock market will continue to find sponsorship.

Firstly, with the helping hand of the Fed, the favourable interest rate differentials vis-a-vis the developed world and better economic prospects than most of the advanced economies, the dollar is well anchor to keep it's safe haven appeal. This puts a lid on U.S. government bond yields.

Secondly, the inflationary scare is abating. Even though unemployment is a mere 3.9%, wages are not rising much faster than they have for many years. There is a downward nominal wage rigidity that makes employers reluctant to grant large wage increases in good times as a way to compensate for bad times when they are stuck with wages that they cannot downwardly adjust. In any case, wage growth is only moderately firming up, increasing 2.6% over the past year. Productivity has also increased and is officially up 0.8% on the year. Core inflation is well contained. On Wednesday, the Bureau of Labor reported that the core producer price index increased 2.1%, the same number as the past three months signifying that inflation pressures are not an immediate concerns. Additionally, core consumer prices were up 2.1% on the year in April. I should add that it's been rare for annual core inflation to run 0.5% points above the 2.0% Fed's target. It has happened only once since 1993. It may surprise many that the Cleveland Fed's Inflation Nowcasting model is predicting that core PCE inflation will only run at the annual rate of 1.6% during Q2/2018.

Thirdly, the belief that global growth was about to surge to outrageous proportions has eroded. Cracks in the growth narrative are mostly evident in Europe, Canada, the U.K. and Japan where business surveys and data have suffered several setbacks. Data shows that global growth from exceptionally high cyclical rates in the last half of 2017 has fallen sharply with only the U.S. and Chinese growth running above trend. The point is that the overall global picture can no longer be described as one of synchronized above-trend growth. World growth hovered around an annualized rate of 4.75% in the second half of 2017. Nowcast models are not pessimistically pointing to a recession. They are merely suggesting that the decline in growth represents nothing more than a return to trend. We are back to a 3.5% growth world.

Fourthly, despite jitters, soft indicators of sentiment across the globe remain good. Market statistics show that long-term rates have risen mainly because of structural factors including the dullness of productivity and risks of deflation that are dissipating. This is good news as it shows an environment of robust operating leverage for businesses, firm investment expenditures, pricing power for corporations and a healthy backdrop for more normal interest rates. According to Factset, the Q2/18 bottom-up EPS for the S&P 500 Index estimate (which is an aggregation of the median EPS for all the companies in the index) is $39.96, up 28.7% from Q2/17. The Q3/18 estimate is $40.65, up 31.2% from Q3/17. Many investors believe that we've reached peak earnings and are wondering what's next. There is historical evidence that strong earnings growth is often associated with lackluster equity returns. This is why the stock market is treading water right now. What happens comes down to whether growth actually contracts. Morgan Stanley went back 50 years to find out that the S&P 500 posted positive returns 70% of the time with yearly median gains of 7.7% after earning actually peaked. In other words, profit peaks do not spell the death knell for stocks. While we recognized that earnings growth is rolling over, it's also important to highlight that under and a two-plus-two economy (two percent growth and two percent inflation) earnings should keep on growing, albeit at a slower pace. The bottom line is that S&P 500 earnings are still projected to rise 10% in 2019 and 2020. Price-earnings ratios based on these projections are within historical averages.

Lastly, there is ample proof that advanced economies cannot accelerate growth above the 2.0% threshold unless stimulated by exceptional monetary or fiscal policies. The market for inflation-index imply that real interest rates will be kept below 1.00% for the next 30 years. If budget deficits had been normal and not risen faster than aggregate spending and real interest rates were closer to their customary 2.00% level, it's almost inconceivable that there would have been any growth at all or inflation near the Fed's 2.00% target. The fact of the matter is that the U.S. economy is stuck with 2.00% growth and 2.00% inflation for as long as the Fed keeps the federal funds rate below 2.5%, the neutral rate, and avoids the curse of an inverted yield curve. History is conclusive that regimes of moderate but stable growth are amicable to stock market returns.

What's Going on Right Now: The U.S

On May 9, the Atlanta Fed's GDPNOW forecasting model estimated that R-GDP in the second quarter of 2018 will be 4.0%, down a bit

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from the 4.2% estimate of April 30. On May 10, Moody's high frequency economic model revised downward its estimated growth for Q2 to 3.1%. The Cleveland Fed's Inflation Nowcasting model is suggesting that the Core PCE inflation is currently running at the annual rate of 1.6%. Meanwhile, the Federal Reserve Bank of St-Louis reported on May 10 that it's financial stress index is easing and Moody's Analytics currently calculates that there is only a 12% chance that the economy could be in a recession in six months from now, up from 10% in April. However, Moody's uncertainty policy index is climbing and touched 127.7 on May 9 because the dynamics in Washington are perceived as being complicated. Palos calculated on May 10 that the U.S. neutral rate was 2.68%, 83 bps more than the yield on three-month treasury bills.

What's Going on Right Now: Canada

Moody's high-frequency model projects that Canada's first quarter economic growth will likely be disappointing, advancing at the low annual rate of 1.6%. The Palos monetary policy model suggests that Canada neutral rate is only 2.00%, about 70 bps lower than the one in the U.S. but 75 bps higher than the Bank of Canada benchmark rate of 1.25%. The Canadian dollar was 78.25 U.S. cents on Thursday morning, very near our estimated purchasing power parity rate of 79.00 us cents. The current strength of Loonie is certainly reflects rising oil prices and price data misses in the U.S.. Moreover, Thursday's Gartman Letter suspects that something good is going on regarding NAFTA for the Mexican Peso is uncommonly strong.

Technical Perspectives of the Sevens Report (May 10, 2018)

1. Volatility has lessened and the broad uptrend in the S&P 500 remains intact with a key support level at 2569 and a key resistance at 2816. Bullish

2. WTI Crude Oil broke out to a new multi-year high, underscoring the decidedly bullish trend with a key resistant level at $73.43 and key support level at $66.67. Bullish

3. The gold market has been choppy in a largely trendless manner for months with key resistance at $1405 and key support level at $1278. Neutral

4. The 10-year yields hit new multi-year highs, underscoring the decidedly positive trend with key resistance at 3.15% and key support 2.76%

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