Issue 20

PALOS

May 17, 2018

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■Portfolio Management & Advisors

Charles Marleau, CIM
CEO & Senior Portfolio Manager

Noah Billick
President, Wealth Management

Hubert Marleau
Economist & Co-Founder

Wakeham Pilot
Chairman, Wealth Management

Robert Mendel
Senior Portfolio Manager & Options Strategist

Joany Pagé
Associate Portfolio Manager

Evan Weiser
Junior Analyst

Karim Rhoualem
Financial Analyst

■Contacts

Palos
1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada
T. +1 (514) 397-0188 F. +1 (514) 397-0199
www.palos.ca

Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

The Spartan is Holding Back the Vermillion

On April 16, 2018 Vermilion Energy Inc. (TSX:VET) announced that they were buying Spartan Energy Corp (TSX:SPE) for C$1.40 billion. The deal was done at very attractive metrics. This will add 23,000 bbl/d of production, 480,000 net acres of land, 113.5 mmboe of 2P reserves and over 1000 locations. VET paid 4.9x P/CF which is very reasonable for light oil, and high netback assets.

The acquisition of SPE has kept a top on VET, which in our view brings opportunities. VET is probably the only high-quality E&P that did not participate in this oil rally because of the acquisition overhang. In addition to making an accretive acquisition, VET has international exposure which gets Brent pricing ($80 USD).

Palos believes the overhang is coming from the arbitration between VET and SPE. This kind of activity probably kept some negative pressure on VET. Palos saw this price action as a perfect pair trade opportunity. The stars where aligned, fundamentally and statistically.

Palos rarely sees these kinds of opportunities. However, when they do occur they are usually very lucrative. Palos knows that the arbitration overhang will abate overtime, and VET will become a catch-up trade. Palos likes the risk reward and accumulated VET and shorted the XEG index to reduce some of the oil market risk.

■ Mendel's Option Corner

By Robert Mendel

How do you define risk? For me it's eating my aunt's food when she invites me for dinner, that's for sure.

But when I am selling calls or puts it is less certain. Do I define risk as total exposure to my maximum loss? Do I define risk as how close the option is to the strike price or maybe somewhere

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$10.01	0.95%
Palos Equity Income Fund - RRSP	PAL 101	$6.59	0.13%
Palos Merchant Fund L.P. (Dec 29, 2017)	PAL 500	$4.61	15.26%
Palos WP Growth Fund - RRSP	PAL200	$9.57	-10.51%
S&P TSX Composite			0.66%
S&P 500			2.50%
S&P TSX Venture			-8.09%

Chart 2: Market Data*

	Value
US Government 10-Year	3.11%
Canadian Government 10-Year	2.52%
Crude Oil Spot	US $71.49
Gold Spot	US $1,289.90
US Gov't10-Year/Moody BAA Corp. Spread	179 bps
USD/CAD Exchange Rate Spot	US $0.7808

* Period ending May 17, 2018

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in the middle? Let's look at both. And then you decide.

Take for example Boeing at $345 per share and the August 345 put priced at $17 and the August 300 put at $4. I will use 1 contract (100 shares) as the multiplier.

If we sell the 345s we pocket $1,700 and have $32,800 maximum potential loss (345-17) if the stock goes to zero. If we sell the 300s we receive only $400 but have a maximum potential loss of only $29,600 (300-4). While we receive less money for the 300s, our max loss is also less since we have more downside protection (again downside protection is defined as how far away from the strike price you are). Here Boeing is 13% from the strike but the 345s are right at the money.

So is this a safer option? Not so fast. To get the same dollar value of $1,700 you would need to quadruple up the position ($400 x 4) since now you need to sell 4 contracts, not 1. And 4 contracts means a total maximum exposure of $120,000 (4 x 300), not the original $29,600 we calculated. So if you look at it this way the 345s may very well be a safer play, if matching dollars is what you want.

Like I said, 2 ways to look at it. One thing is for certain though. You don't want to join me for Friday night supper at my aunt's house.

■ What is New on the Macro Level?

By Hubert Marleau

The Bond Market: It's About the Neutral Rate

The Bank of Canada defines the neutral rate of interest as the real policy rate that prevails when an economy's output is at its potential level and inflation is at the central bank's target, after the effects of all cyclical shocks have dissipated. The neutral rate serves as a benchmark to gauge the degree of monetary stimulus in place and provide a medium-to-long-run anchor for the real policy rate. Put simply, it's a claim that there is a unique rate of unemployment consistent with stable inflation.

There is a lot of misunderstanding surrounding how the Federal Reserve works and how its decisions actually affect the economy and the interests of market participants. The economy is like a car with many components: consumers, foreign customers, government entities and businesses. The economy is sparked with either public policies and/or entrepreneurism but fueled by money and lubricated with liquidity. In a modern economy, the monetary authorities are the ones that decide how much fuel and grease they are ready to give. They use two gauges to figure out what they should do: employment and inflation. Congress has given the Fed a clear mandate to promote full employment that is calculated to be about 95.5% of the labour force and price stability that is defined as an inflation target of 2.0%. Unofficially, the Fed is also concerned to a lesser extent with economic growth and the viability of the balance of payments. The central bank will use various tools like moral suasion, reserve requirements, quantitative purchases or sale of assets, open market operations and federal funds rates to adjust the cost of money in the economy and, by extension, credit availability for the economy and liquidity for the systems. The big stick and most used tool by the monetary authorities is the federal funds rate. It represents what banks charge each other for overnight loans to balance reserves. The ultimate objective is to keep the economic engine running well which means full employment with controlled inflation combined with moderate long-term rates and normal financial conditions. Currently, both the financial and economic environments are in perfect unison, maybe even too perfect to be believe. Some believe this is "as good as it gets."

Firstly, the unemployment rate is 3.9% and total employment is up 1.3% on the year. The simple story is that the economy is adding jobs in sufficient numbers to satisfy people entering the workforce and offset baby boomers' retirements. If one was to assume that full employment is set at 96.0 % of the labour force, it would take only 94K net new jobs for the economy to stay fully employed. The Labor Department reported a few days ago record 6.6 million job openings at the end of March, enough to provide every unemployed person with a job. While we recognize that skill and geographical mismatches do not guarantee that everybody can get work, the relationship between the unemployment rate and the job opening rate, known as the Beveridge curve, means that future employment increase should match labour force growth.

Secondly, the Core Personal Consumption Expenditures Price Index, the preferred inflation measure of the Fed, almost met the policy makers' target, increasing 1.9% on the year in March. In so far as the market is concerned, the inflation rate is on target. What is particularly interesting is that all the various inflation indices took a breather in

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April keeping the underlying trend just about where the Fed wants it. There has been no broad-based gain in inflation. We saw one hard print, a few soft ones and a number of declines. The core CPI registered a three-month annualized gain of 1.8%, the Producer Price Index (PPI) for personal consumption, a useful window of personal consumption expenditures price index, has hardly moved since February and import prices have been rather weak rising at the annual rate of 1.2% over the past three months. Wages, which are the major direct feed into core inflation, are growing only moderately. Average hourly earnings increased at the annual rate of 1.6% in the three months ended April resulting in a 2.6% rise for the year. Given that productivity is running at the annual rate of 0.8%, it leaves 1.8% (2.6% less 0.8%) for core inflation at a time when the deflationary power of technology is still about. Tech-related deflation is a big part of what is keeping inflation in check. So are inequalities and demographics. There is little wonder that market-based measures of inflation expectations remain centered near the FOMC's two percent target, signaling that investors are confident that the Fed is credible and willing to uphold the target. Some say that we should not ignore rising gasoline prices even though they are not reflected in the core inflation measure the Fed focus on. "There is a good reason for this since energy prices can bounce around as a result of temporary factors that don't reflect what is going on with the overall economy" says the WSJ. Since gasoline and food are among people's most frequent purchases, rising prices for these items usually brings about lower real expenditures on other less price-sensitive products and services. This ends up reducing economic growth. During the month of April, retail sales rose less than expected because expenditures on fuel climbed 0.8% month over month, sapping people's pocket money. In fact, it was not much of an increase when one factors in that the U.S. just got a fresh round of minimum-wage increases, personal tax cuts and lower unemployment.

There is evidence here to support the idea that the economy is in a sweet spot in that is neither too cold nor too hot. This strongly suggests that the federal funds rate may have almost reached its natural level that will neither push inflation up or pull unemployment down. The authorities will likely add two additional quarter points to their policy rate as a margin of prudence to offset the possible overheating impact of burgeoning deficits and deregulation. However, the Fed might not move beyond the neutral rate of 2.25%. On the contrary, the Fed may pause in order not to upset the rare obtention of an economic equilibrium. Governor Kaplan of the Dallas Fed thinks that we are indeed near the neutral rate. Two permanent-voting members Richard Clarida and John William, who's station at the FOMC is of serious significance, are likely to agree with Governor Kaplan. Their intensive research on the subject suggests that the neutral rate is much lower than the official estimated level of 3.00%. Firstly, Richard Clarida, Vice-Chairman of the Federal Reserve Bank, rationalized that the neutral rate is a function of differentials in the yield curve. To determine the neutral rate, the spread between ten-year and two-year treasury yields should be deducted from the yield on two-year treasury notes. This is how professional traders and speculators calculate what the cost on money should be outside of the current business cycle. In today's market, it would imply that the neutral rate is 2.25%. It's a simple but robust model that adapts easily to regime changes and structural shifts making it more flexible than econometrics. Secondly, John Williams, Governor of the NY Fed, and Thomas Laubach, Director of Monetary Affairs at the Federal Reserve Board, rationalized that by observing the performance of the economy in real time, one can determine if the neutral rate was appropriately estimated or not. It's also a rather simple model but it has proven to work quite well. If the economy turns out to be too hot, the actual policy rate must have been below the neutral rate. If the economy is too cold the policy rate must have been above the neutral rate. Logically, we must be at or near this equilibrium point where the neutral rate equals the policy rate sine the economy is at full employment and the rate of inflation right on target. Many macroeconomists are willing to adopt this new natural rate hypothesis. The natural rate adjusted for inflation has been at or below zero since 2008. That contrasts with the 50-year average for the real policy rate of about 2 percent. So what's causing the change? The Laubach-Williams model attributes it to the decline in the trend growth rate of the economy. The model claims that the potential output is about 2.1% down from 3.5% in the 1990's. Basically, the case for lower policy rates than the level needed in the past to sustain a given level of economic activity is much stronger than we used to think. It also means that output lost to demand deficits or to supply surpluses are lost forever with little chance to make up for it later. This suggests that too many rate hikes would be a bigger sin than leaving rates alone. The new narrative is no longer full employment but stabilization of employment because the risks of being too loose versus too tight are asymmetric. The Congressional Budget

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Office forecast calls for annual growth of 2.5% over the next three years. To support this growth, the CBO projects increases in budget deficits of more than 1% of GDP with a substantial rise in the debt-to-GDP ratio and the maintenance of real interest rate well below 1% for the next 10 years. Charles Eliot of Harvard University believes that "secular stagnation is an issue that remains very much alive." If the budget deficits had been at normal levels and not growing relative to the economy, and real long term interest rates had been steady in their customary range above 2%, it is hard to believe that the economy would have grown at all and almost inconceivable that it would be near its 2% inflation target. What we are seeing is the achievement of ordinary growth with extraordinary public monetary and fiscal policies. We should be thankful that we may be redeemed with luck. Productivity is finally creeping up. It looks as if there will be enough productivity gains to keep inflation in check near the 2% level and offset the inevitable rolling over of employment growth to zero by 2020. This should keep the annual increases in the level of business activity near 2.0%. In fact, U.S. companies are ramping up capital spending on their businesses at the fastest pace in years. This is a long-awaited development following years of tepid growth. The WSJ reported that spending on factories, equipment and software by companies in the S&P 500 rose 24% in the first quarter of 2018 to $166 billion, the biggest increase since 1995 when productivity gains were exceptionally high. The big spenders come from technology behemoths to large auto makers and giant oil firms. This is a home run for productivity and for the economy. Rising productivity allows wages to grow without triggering inflation since unit prices of goods and services actually falls. If barriers, lags, transactional cost and friction are, indeed, dissipating, a capex revival may bring about a better rational for a surge in the level of economic activity. McKinsey's analysts estimate that this greater investment could boost productivity growth by 0.8%, while the tech component itself could easily add another 1.2%. That's a total addition of 2.0% to the approximately 0.8% productivity we've been stuck with. It would only take 100k new jobs per month to raise the level of economic activity to a sustainable path of 3.0%. It would probably also temporarily raise inflation to 2.5%. Of course, not everybody is buying into the previously mentioned scenarios. There are some who believe that it won't work since a strong dollar being is a good thing is not as sure as it once was. Trade protectionism and the huge dollar-denominated debt of emerging countries (which grew 10% in 2017 to $3.7 trillion according to the Bank of International Settlements) is slowing cross-border bank credit and spilling over into slower global growth. Disappointing economic results are showing all over the world in countries such as Japan, Canada, U.K., France, and Germany. The relentless flattening of the yield curve, the rising real interest gap, and excess risk premiums are making them nervous. Nevertheless, the probability of a recession over the next 12 months is only10%. In our judgement, the causation of narrower spreads in term-duration is more related to the normalization process of rates than a contraction predictor. While it is obvious that the odds of a recession risk rise with long-term time horizons, it is hard to find serious analysis that suggests that a recession is around the corner. Most claim that we are late in the business cycle. We may very well be, but it's only an observation and not research. Guggenheim has an interesting Recession Probability Model that uses six indicators that have exhibited consistent cyclical behaviour: the unemployment gap (unemployment rate less natural rate of unemployment), three month less ten-year yields, leading economic indicator (year over year percent change), aggregate weekly worked (year over year change) and real retail sales (year over year percentage change). If one was to overlay the current cycle of these indicators over the last five economic cycle, the picture would suggest that we are not in danger of a recession until the middle of 2020.

Bottom Line: 12 Month Outlook

Given that it is a well-established fact that bond yields are tied to the ups and downs of the economy, investors tend to follow the direction of inflation and the pace of growth. In this connection, we have three scenarios based on the narrative:

Scenario one is "two-plus-two economy" with 2% growth and 2% inflation with an estimated probability of 55%. Bond yields range from 2.75% to 3.25%.

Scenario two is a "one-plus-one and a half economy" with 1% growth and 1.5% inflation with an estimated probability of 10%. Bond yields range from 2.00% to 2.50%.

Scenario three is a "three-plus-two and half economy" with 3.0% for growth and 2.5% inflation with an estimated probability of 35%. Bond yields range from 3.50% to 4.00%

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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 4.1%, down a bit from the 4.0% estimate of April 30. On May 17, Moody's high frequency economic model had an 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 17 that it's financial stress index continues to ease 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 was unchanged on May 15. Palos calculated on May 17 that the U.S. neutral rate was 2.25%, 36 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%. Palos calculates that Canada's neutral rate is only 2.00%, about 75 bps higher than the Bank of Canada's benchmark rate of 1.25%. The Canadian dollar was 78.15 U.S. cents on Thursday morning, less than our estimated purchasing power parity rate of 79.25 U.S. cents, despite strong oil prices. This is mainly about different monetary stances between Canada and the U.S. as well as NAFTA delays. On a forex adjusted basis, the Canadian stock market is outperforming the S&P 500 from a ratio of 435X on March 15 to 464X today.

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 2581 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 $67.50. Bullish

3. The gold market has been choppy in a largely trendless manner for months with key resistance at $1405 and a 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%. Bullish

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