Issue 25

PALOS

June 21, 2018

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

No love for Bank of Nova Scotia

Since the beginning of spring, the Bank of Nova Scotia (TSX:BNS) has been significantly underperforming the other Canadian Banks. BNS has lagged its peers by over 10% for two main reasons. The first is the acquisition of MD Financial (MD). The MD transaction is a great deal for BNS and very strategic as it brings a pipeline of high net worth clients to the bank. However, BNS had to significantly pay up for the asset. They paid $2.6 billion, or 7% of AUM, which is the highest multiple we have seen in the industry. The market may be shocked by the price paid and may be focusing on the acquisition being dilutive to EPS for the next two years. In our view, the dilution is very mild for such an asset and BNS has a reputation for efficiently integrating acquisitions. Furthermore, the market seems to be ignoring the upsell opportunities of this new client list.

Due to the bank's exposure to Mexico, which is approximately 7% of its consolidated earnings, BNS will face more headwinds such as NAFTA and the Mexican elections. Mexico has been a real growth avenue for the bank. One of Palos' senior analysts had the chance to sit down with BNS' head of international banking. He believes that the international banking division can easily achieve 9% earnings growth and that the geopolitical risk in South America has been stable, if not good with the Chilean and Colombian election outcomes. According to management, Mexico remains stable and does not see significant risk from NAFTA.

BNS looks very compelling in our view and is now trading well below its peers on historical evaluation. See below for a visual representation of BNS' underperformance against the financials ETF.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.98	0.62%
Palos Equity Income Fund - RRSP	PAL 101	$6.57	-0.07%
Palos Merchant Fund L.P. (Mar 31, 2018)	PAL 500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL200	$9.50	-11.19%
S&P TSX Composite			2.12%
S&P 500			3.81%
S&P TSX Venture			-11.13%

Chart 2: Market Data*

	Value
US Government 10-Year	2.90%
Canadian Government 10-Year	2.14%
Crude Oil Spot	US $65.80
Gold Spot	US $1,267.20
US Gov't10-Year/Moody BAA Corp. Spread	191 bps
USD/CAD Exchange Rate Spot	US $0.7510

* Period ending Jun 21, 2018

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■ Mendel's Option Corner

By Robert Mendel

Toilet paper saved me. No, no, no… Get your mind out of the, ahem, toilet. Let me explain.

I was dropping off my son at his friend's house. His friend's father loves to talk (and talk and talk) and the conversation turned to stocks, specifically Amazon shares. Now, I have been invested in the company with a core position for several years and have also traded around it but had no current trading play. It was February, and of course another warm winter day here in Montreal, and at this time Amazon had pulled back from the high 1400s and was in the $1,350 range. I began to wonder about re-entering at this level. I was having my doubts, but then, as if a voice from heaven, the friend's father said this: 'Hey, you know I buy my toilet paper on Amazon?'

That clinched it. The next day, I bought Amazon at $1,328 and simultaneously sold the April $1,480 calls for $55, bringing my cost to $1,273 (again, this caps me at $1,480). Of course, since you can't keep a good toilet paper company down, the stock come April was at $1,600. Like the Goldman Sachs example of a few issues ago, I had similar choices here (let it go or roll it, since it's the same basic principle but in reverse).

As I still wanted to stay in, I rolled the April calls to June 1480 calls for a $11 net credit (bought April for $126 and sold June for $137). This lowered my cost to $1,262. Fast forward to June, the stock was even higher and over $1,700. I rolled once again, this time to August but I also increased my strike price to $1505 and did this for a further credit of $1.30, bringing my cost down to under $1,261. My thinking to raise the exercise price was based on wanting to walk up my strike slowly until it reached a level where I no longer cared about participating.

The stock now sits at $1,758. If I don't roll on August expiry and let it go I will end up making 19% in six months. Not bad, with this profit I can buy a year's supply of toilet paper.

■ What is New on the Macro Level?

By Hubert Marleau

The Outlook for the Stock Market:

On January 26, the S&P 500 index peaked at 2873, the P/E ratio was 18.67, and the index was generating an earnings] yield of 5.35%. Investors were willing to take a chance for superior equity returns by paying an extra 269 bps above ten year treasury notes, but the bet did not pay-off. On June 20, the S&P 500 was at 2765 - it was down 3.8%, but it did produce a dividend yield of 0.87% for the period under review. At that time, junk bonds were paying 5.54% - 19 bps more than stocks - and the reliable "rule of 20", which is the addition of the P/E ratio to the year-over-year increase in the CPI index, was 20.77 (18.67x plus 2.10%). On average, stocks were yielding a dividend of 1.75% - 20 bps less than two-year treasury notes. Overall, the stock market was not in bad shape back then, but there were only even keel odds that the market could produce superior returns according to the aforementioned valuation metrics.

On June 20, the S&P 500 index was 2765, the P/E ratio was 17.20 (with an associated an earnings yield of 5.81%), and the dividend yield was 2.01%. In this connection, investors are presently prepared to pay an extra 287 bps over ten-year treasury notes (2.94%) and accept 55 bps less in dividends than the amount of interest that two year treasury notes offer. The rationale in doing so is to gain exposure to the usually better returns of the equity market. At this time, junk bonds are paying 6.20% - 39 bps more than stocks are currently giving in earnings yield, while the "rule of 20" was 20. Simply put, the stock market is pretty much in the same place as it was last January. An explanation is needed as to why the market is stuck in the mud. There are two main concerns that trouble the market since the beginning of the year: annoying trade disputes and stagflation fear.

First, trade disagreements have turned into disputes and now into trade wars. It started with tariffs on lumber and washing machines, to steel and aluminum tariffs on friendly nations, followed with additional ones on China worth $50 billion. Now there is talk of levies on cars and auto parts and a possibility that the U.S. could pull out of Nafta. On Tuesday, trade tensions intensified another notch as the Trump Administration proposed an additional $200 billion in tariffs on Chinese imported goods and later in the day he floated $450 billion worth of total tariffs on Chinese goods. The total of $250 billion accounts for 50% of goods imported from China and 1.3% of the U.S. N-GDP. What's troubling investors is that since the end of WWII, there was a global movement toward more free trade. As a general rule, tariff rates on dutiable imports plunged from 30% to 6%. Today the effective rate on all imports is only 1.5% and liberalization is institutionalized into global organizations like the WTO, EU, NAFTA, ASEAN, and many others. The reforms

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brought about serious technological advances in shipping - leading to reductions in cost, shortening of distances and increased cargo. Consequently, trade volume surged, doubling the rate of global GDP. At the present time, the impact of the new measures are not catastrophic. The magnitude of the impact on economic activity is very limited and piecemal. What's scary is that trade protectionism has become more about politics than economics. Since the end of the financial crisis, the movement towards less strict rules for more international commerce considerably slowed down. The collapse of the WTO's Doha round, the failure of the TPP, and the divide of the G-7 are good reasons to believe that protectionism is here to stay. Given that the US economy is doing pretty well, Trump may double down. But, there is no way that China will retreat from its industrial policies, or that Mexico and Canada will permit being push around, or that the EU will just sit back and watch. In this connection, it is understandable that investors are not totally complacent about the potential ill effect of protectionism. The reality is that tariffs lead to subtitutions, alternatives and disruptions. That can only reduce growth and raise inflation and, in turn, promote stagflation. The impact on GDP growth of 25% tariffs on $50 billion, plus 10% tariffs on $200 billion worth of U.S. imports from China, and one-to-one retaliation by China would reduce real GDP in China and the U.S. by about 0.3% and 0.2%, respectively, in 2019 and 2020. China can't match the scale of the White House's latest threats, but it could respond with several penalties to upset U.S. business interests in China through boycotts, custom delays, tax audits, regulatory scrutiny and limits. It could also unleash its massive trade weapon, that is, ceasing to buy U.S.treasuries or even sell their holdings. In some way, the concern or optimism is transmitted to the DJIA because it is overweighted with stocks such as Boeing, United Technology, and Caterpillar, and too overleveraged stocks that stand to bear the brunt of trade hostilities between China and the U.S. Observations show that the DJIA has not done as well as other indices and credit spreads have widened since Trump took office. As a rule, the market value of companies with big export markets and production facilities in China has been damaged with lower peaks combined with lower lows since the end of 2017.

Second, stagflation fears are somewhat warranted. The U.S. economy is booming this quarter as tax cuts are powering consumer and business spending. Economic growth has a fair shot at reaching an annual rate of 4.0%, yet risks are mounting and the high may be short-lived. There ais talk that the housing market may be headed for a slowdown, manufacturing is coming off the boil, business equipment demand is simmering down, and the looming trade wars are taking a bite of the economy. Luckily, there is no stress in neither the banking sector nor the financial markets and confidence at both the consumer and business levels is favorable. Nevertheless, copper prices have fully re-traced their impressive June bull run and are now boxed in between $2.95 and $3.30 per pound, and the yield is flattening while inflationary pressures are broadening. The NY Fed's new Underlying Inflation Gauge (UIG) is an inflation metric that extends beyond conventional price variables by incorporating asset prices - an acknowledgement of what was sorely missing in the years that led up to the financial crisis. The UIG was up 3.20% in May, compared to 2.54% a year ago. The risk is that full employment has already arrived and the Fed is willing to allow inflation to overshoot. The monetary authorities admit that they want to normalize interest rates even though they seem aware that the current growth path is unsustainable.

Conclusion:

Firstly, we have not given up hope that the trade war will be contained to China. In an interview with the economic club of NY, Lloyd Blankfein, CEO of Goldman Sachs, cited that Trump's tariff threats make sense as a bargaining strategy and thinks that the Administration wants to remind their trading partners that the U.S. has firepower. It's interesting to note that Germany's largest auto companies back the abolition of EU-US car import tariffs. It's like a peace offering. That would mean scrapping the EU's 10% tax on auto imports from the U.S. and other countries and the 2.5% duty in the U.S. - a possible tipping point back to reasonable negotiation and cooperation. Game theory may offer an explanation. Tit-for-tat is part of it. Put simply, it goes like this: "as long as you cooperate, I will too, but if you try to win at my expense, I will punish you." It's a schoolyard rule and works for most part. But, in cooperative games, one little slip up and the cooperation of tit-for-tat unravels and retaliations set in. I cannot help to think that in the end, sensible governments will avoid what constitutes offensive behavior. "Tit-for-Tat" can trigger a cascade of vengeance and become a death spiral.

Secondly, as we have argued in past weeklies, I believe that monetary policy's goal of normalization will take more time than expected given that exhausting employment growth is upon

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us. The determinant of growth will change from employment to productivity, and, in turn, keep both inflationary pressures and growth around 2.0%. Take note that according to Palos' metrics used to gauge the level productivity, it looks as if productivity increased year-over-year by as much as 1.6% during the second quarter of 2018 - a very respectable gain. Productivity has been on a slow but gradually growing trend since the middle of 2016. Given that yearly increases in employment will slow down to a low 0.5% over time, productivity is slowly becoming the key growth factor, and that is a good thing.

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

On June 21, the Atlanta Fed's GDPNOW forecasting model estimated that R-GDP in the second quarter of 2018 will be up 4.7%, a small decrease from the last estimate. GDP growth for the second quarter is expected to show some serious improvement in productivity - the economy's long missing ingredient. The Cleveland Fed's Inflation Nowcasting model is suggesting that the Core PCE inflation is currently running at the annual rate of 1.9%, up from 1.6% two weeks ago. Atlanta Fed's Business Inflation Expectation is 2.0%. The Federal Reserve Bank of St-Louis reported on June 21 that its financial stress index continues to ease and Moody's Analytics currently calculates that there is a 16% chance that the economy could be in a recession in six months from now, up from 12% in May. Interestingly, Moody's uncertainty policy index is stable despite complicated dynamics with the trade dispute. This may change because corn, wheat, beef, soybean and pork are all suffering market price declines. With every passing day, the U.S. is losing market share to other countries. Some say that Kraft-Heinz may move its ketchup production back to Canada. The best one comes from the republicans on the Senate Finance Committee: "Ross is 80 and wears eyeglasses and a hearing aid and did not see or hear bipartisan anger."

Palos calculated on June 20 that the U.S. neutral rate was 2.82%, 90 bps more than the yield on three month treasury bills - four hikes for an inverted yield curve. Watch copper prices ($2.75 would be bad) and oil prices ($90 a barrel would be bad). Herein lies the secret as what could be ahead of us. We are far away from a combination of an inverted curve combined with much lower copper prices and much higher oil prices - we monitor these variables on a daily basis.

What's Going on Right Now: Canada

Canada's first quarter economic growth was very disappointing, advancing at the low annual rate of 1.3% (we expected 1.6%). On a comparative basis, inflation rose at an annualized rate of only 1.2%. Should later numbers persist, we could see more downside pressure on the Loonie. Expectation for the second quarter is better - perhaps 2.5% because April exports rose to a record high, significantly above expectation. Canada's merchandise trade deficit narrowed in April to $1.90 billion from $3.40 billion in March. Palos now calculates that the Canada neutral rate is 2.02%, 77 bps higher than the Bank of Canada benchmark rate of 1.25%. It means that if the Bank of Canada was to hike the policy rate three times, Canadians would face a possible recession. The Canadian dollar was 75.08 U.S. cents on Thursday morning, much less than our estimated purchasing power parity rate of 79.75 U.S. cents. The Loonie is not doing badly. There is division of opinion as to whether the Bank of Canada will increase its policy rate in July. Palos believes that current economic data do not support a rate hike. On a forex adjusted basis, the Canadian stock market has outperformed the S&P 500 - the ratio hardly increased from 435x on March 23 to 446x today, but far away from the ratio of 490x at the end of December 2017. Loonie weakness is creating a compression effect on the Canadian stock market returns. It's interesting to note that Canadian companies that have significant exports to the U.S. or have large amounts of U.S. assets have not performed well, yet they should be profiting from better margins or translation gains.

The Global Energy Complex

Geopolitical tension explains the $11 premium that oil producers are getting over their marginal cost of production, and oversupply of oil in the U.S. has brought about a $10 premium for internationally produced oil above the U.S. price of $65 per barrel. We made the bet that Opec will ignore the complaints of Iran, Iraq and Venezuela and raise oil output sufficiently - between 300,000 to 600,000 barrels a day - to dent oil prices. Saudi Arabia and Russia are a formidable duo. Together, they pump about five times what Iran and Iraq do individually, and 15 times Venezuela's output. In any case, should Trump think that the Opec increase in oil production is not enough, the administration could easily sell some oil in the market from the U.S. Strategic Petroleum Reserve. Voila.

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Technical Perspectives of the Sevens Report (June 21, 2018)

1. Reduced volatility is helping the broad uptrend in the S&P 500 with a key support level at 2675 and a key resistance at 2790. Bullish since November 7, 2016.

2. WTI Crude Oil recently broke out to new multi-year highs, underscoring the decidedly bullish trend with a key resistance level at $68.24 and key support level at $59.35. Bullish since October 30, 2017.

3. Gold market has been choppy and largely trendless for months, breaking to the downside with key resistance at $1278 and key support level at $1227. Neutral since December 4, 2017.

4. Government bond yields are slowly rising with the 10-year bond yields, and are decidedly in a positive trend with key resistance at 2.98% and key support 2.73%. Bullish since January 8, 2018.

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