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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Iso-Octane Drives Keyera's Big Earning's Win

On August 08, 2019, Keyera Inc (TSX:KEY) announced their second quarter earnings and they were impressive. KEY posted an adjusted EBITDA of $210 million versus the street consensus of $170 million. The beat came from the marketing business, as they experienced record iso-octane margins. With these stellar results the company increased its dividend by 7% to $1.80 per share.

KEY also has $2.5 billion of secured growth projects. This development will allow KEY to diversify its gathering and processing into their two key areas, the Montney and Duvernay basins.

In addition to the strong earning and growth prospects, KEY's balance sheet is strong, and its payout ratio is lower then its peers at 55%. The funds continue to hold KEY as a core position, as I see KEY as a safer way to invest in energy with a 4.75% yield.

■ Mendel's Option Corner

By Robert Mendel

I was short Tesla calls going into earnings last week on Aug 01. The report was 'decent' if I can use that word, since the company didn't burn as much cash as the market expected. The result? The stock shot up.

Tuesday there was a headline that the Saudi Arabia Sovereign Wealth Fund acquired a 3-5% stake in the company and the stock shot up even more.

And just a little after that, Elon Musk, the CEO, tweeted that he is thinking about taking the company private at $420 a share. The stock shot up even more.

So am I getting killed? Well yes and no. Let me explain.

On Aug 01, before the earnings, I sold 2 Aug 03 300 calls for $11.70 putting my break-even at $311.70. After the earnings the stock rose to $349. Sticking with my short thesis and not wanting to move my strike higher, I rolled the Aug 03 options

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.71	-0.06%
Palos Equity Income Fund - RRSP	PAL 101	$6.42	-0.87%
Palos Merchant Fund L.P. (Mar 31, 2018)	PAL 500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL200	$8.67	-18.97%
S&P TSX Composite			3.02%
S&P 500			7.94%
S&P TSX Venture			-17.64%

Chart 2: Market Data*

	Value
US Government 10-Year	2.93%
Canadian Government 10-Year	2.33%
Crude Oil Spot	US $66.81
Gold Spot	US $1,211.90
US Gov't10-Year/Moody BAA Corp. Spread	184 bps
USD/CAD Exchange Rate Spot	US $0.7663

* Period ending Aug 9, 2018

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on Friday (expiry day) to the Sep 17 300s for an additional $4 bringing my new break-even to $315.70. On Aug 07, the two news releases I mentioned above drove the stock up to over $370. On paper, I was down $55 on 200 shares. Now usually I would wait but this was different. Not too often does a CEO tweet out he would take his own company private and, on the same day, a Saudi fund bought into the company too. So as the expression goes, when there is smoke, there may be fire. This is where one of my three rules I mentioned comes into play. Never ever sell your maximum dollar position right off the bat. By sticking to this rule I allowed myself the ability to increase my exposure by selling more contracts.

So here's what I did. I bought 2 Sep 300 calls for $63.50 which cost $12,700 and sold 5 Jan 400 calls for $26.50 which netted me $13,250. These transactions raised my break-even to $407.38. So if the going private transaction does happen at the price the CEO suggested I would lose $12.62 per share on 500 shares. I can live with that. And if it doesn't happen, I will be making money which is always a nice thing. Following one of my three rules allowed me to fight another day. And now I wait.

Will keep you posted on this.

■ What is New on the Macro Level?

By Hubert Marleau

The Weekly Narrative

The Federal Reserve was not as boring as many analysts thought last week. Fed Chair Powell characterized economic growth as "strong" as opposed to "solid," but what really stood out was two new words. His statement said that gradual interest rate hikes were the plan "for now." It may appear insignificant, but it is not. In so far as I'm concerned, it is a signal that the Fed could potentially pause the tightening process if the policy rate was around the neutral, defined as a rate level that keeps the economy growing on trend with inflation on target over term. Judging by the forward rate overnight index swaps curve, the Fed will stall at 2.75%. There are several ways to determine what should be the neutral rate. My method points to 2.75% to 3.00%. The Fed's semi-annual monetary policy report to Congress issued a few weeks ago confirmed that econometric estimates of the neutral rate showed that the median of 0.75% over the assumed 2% inflation of the FOMC, that's 2.75%. Pimco argues that the real neutral rate is somewhere between 0% and 1.00% which makes neutral between 2.00% and 3.00%.

There is no sense in overthinking it. A reasonable description of the Fed's base-case scenario is to prevent inflation from getting out of hand and to keep the economy at full employment while preserving maximum optionality. It means that the Fed would pause or adjust their forward guidance to avoid a lasting inversion. Several regional Fed presidents, four to be exact, have made up their minds. They have expressed serious concerns about a potential curve inversion. The Fed obviously knows that if ten-year Treasury bond yields do not rise from here, the yield curve will at least be almost flat by year end and possibly invert in mid- 2019, sending a recession signal.

Fortunately, ten-year Treasury yields are not likely to stay around 3.00%. The Yardeni Model suggests that the ten-year Treasury bond yield tends to trade around the growth rate in N-GDP on a y/y basis. During the June quarter, N-GDP was up 5.3% suggesting that ten-year yields should be about 4.00%. That is a bit too much for me as I believe that we are likely to see a 2.5% plus 2.25% economy by the fourth quarter of 2018, 2.50% for growth and 2.25% for inflation. In this connection, I am banking on a ten-year treasury yield of 3.50% and, therefore, no inversion of the yield curve. It should be added that history is clear that long term bond yields are usually about 140 bps above the ongoing inflation rate. This tells us that the Ten's are heading for 3.65%. The big question is whether the forces that have kept ten-year Treasury yields below where they ought to be will dissipate? We think that they will for agnostic ten-year bond yield cannot ignore final demand inflation, the producer price index which measures the price received from the final users of goods and services and goes beyond just commodities capturing the full economy increased 3.3% from a year earlier in July.

Term premium, the extra yield that a long-term investor demands for taking on the risk of price-volatility associated with owning a long term bond, is zero. This depressing effect on term premiums started in 2009 when the Fed decided to purchase large quantities of bonds known as quantitative easing. In 2017, the Fed dropped the program and started to sell assets in the open market with the intention of reducing the size of its holdings of assets. The FOMC plans to taper its balance sheet through the end of 2024. The Fed is on track to slash its holdings of Treasury Bonds and Mortgage Backed Securities by $2.5 trillion

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and $1.7 trillion, respectively, over the next seven years. Moreover, the Tax Cuts & Jobs Act enacted at the end of last year plus additional fiscal spending passed by Congress earlier this year are projected by the Congressional Budget Office (CBO) to result in federal budget deficits averaging $1 trillion per year for the next ten years, about 4.5% of N-GDP. The federal budget deficit was $682 billion for the first 10 months of fiscal 2018 on revenues and outlays that were 1% and 4% higher, respectively, than in the same period in fiscal year 2017. I would be very surprised if the drastically changing conditions in the government bond market don't change the minds of bond investors that current term premiums for long term bonds is too low.

Meanwhile, there are rumors that the widening course of interest rate differentials between the U.S. capital market and that of the other advanced capital markets is about to change. There is a record amount of wealth in Europe, Japan, Switzerland, China, Canada and the U.K. The net international investments position of Switzerland, China, Germany and Japan totaled $8.0 trillion or 40% of the U.S. N-GDP at the end of 2017. A big chunk of this wealth tends to be managed with a risk-off bent and is heading to the U.S. where interest rates are considerably higher and the currency is stronger. This "carry trade" is taking place because the U.S. is the only country that has adopted a program of quantitative tightening (QT) and because the U.S. dollar denominated assets are deemed safe. This is a false perception. Let's have a quick look at some real economic facts and do some analysis instead of reporting headlines. Yields on ten-year government bonds are 250 bps higher in the U.S. (3.00%) than they are in Euro-Zone (0.50%). N-GDP is up 5.3% in the U.S. and 4.0% in the E.U. making a spread of 130 bps. Its means that interest rate differential between the two identities should be 130 bps. This could end badly for the Europeans. The ECB is expected to get off its QE program by the end of 2018. Similar comparisons could be made with a host of other advanced and free capital markets. Let's take Japan as our next example. Japanese influence on the worlds capital market is huge. For decades, the Japanese have been saving huge amounts of money and significantly more than the country needs. They own assets abroad that are less what they owe to foreigners, around $3.0 trillion representing 60% of its N-GDP. Last week, ten-year Japanese bond yields jumped from 0.03% to 0.11% and shocked bond markets all over the world. It may look like a lot of agitation about nothing. It is not. It shows that only a tweak in Kuroda's monetary policy can have significant effects on interest rates around the world including the U.S. and Canada. Kuroda is the head of the Bank of Japan (BOJ). Viewed in another way, the BOJ is committed to buy $700 billion of bonds a year with the aim of keeping 10-year bond yield between 0.00% and 0.10%. And to top it off, the BOJ also purchases every year about $60 billion of domestic stocks. In this connection, there is little need for Japanese savers to keep any money at home. They prefer to buy foreign assets. At the end of 2017, holdings of foreign assets accounted for 185% of N-GDP. The capital outflows are larger than the huge current account surplus which accounts for 3.8% of N-GDP. What will happen to inflation and/or the Yen will matter a great deal on how the BOJ will conduct monetary policy in the future. We know two big unnatural things. Firstly, inflation is running at the annual rate of 1.0% in Japan and yet the BOJ's monetary base has more than quadrupled since April 2013. Secondly, the yen is very cheap and yet capital outflows are huge. Recent experience shows that a minor change in either one of these two things could bring about not only a monetary world change but a change in the direction of Japanese savings. Interestingly, Japanese wages are rising at their fastest pace in more than two decades jumping 3.6% in June from a year earlier.

The Bottom Line: Should the forces preventing long-term inflation and growth expectations from doing their work on bond markets dissipate, the likelihood is that long term bond yields will eventually rise enough to avoid the occurrence of an inverted curve. The chance of a recession would be reduced. Incidentally, there has never been a recession without a sustained curve inversion and not all inversions have ended in recessions.

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

There is a notable decrease in the level of economic activity. The trade deficit rose sharply in June, business activity in both the service and manufacturing sectors decreased, the housing market weakened and payroll employment numbers rolled over. Red flags are not waving for all the aforementioned indicators are still in expansionary mode, but they missed expectations signaling towards my prediction that the annual pace of the economy is heading toward 2.5%. As per the National Association of Credit management, the July GDP proxy slowed to 3.0% from June's 3.9% pace. Number crunchers of ISM reports arrive at a growth proxy of 2.%. Taken together, we get 2.5% growth. It should be noted that the recession risk as calculated by Moody's

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Analytics ticked down to a probability of 14% in July from 15% in June suggesting that although data points, on balance, are lower than expected, on an absolute basis they were fine. Consequently, high frequency economic models are reducing their estimated growth for Q3. I think that lower growth is a good omen as it often means that the business cycle can extend longer than many people think. Interestingly, there is probably a lot more juice in the labour market than assumed. In July, the unemployment rate was 3.9% and the labour participation rate was 62.9%. The last time the unemployment rate was this low was in March 2000 and the participation rate was 67.3% at the time. One could deduce that there are still potential workers lurking on the sidelines of the labour force suggesting the that labour force may run further. Reports show that businesses are paying up and lowering the bar. For as long as people continue to reappear in the labour force, employment growth could conceivably carry on until the unemployment rate reaches 3.0%. It would not be the first time that such a low unemployment rate occurred. Even if participation stays at the same level for the next 12 months, a calculator from the Atlanta Fed shows that the current pace of payroll growth of 200,000 per month would bring the unemployment rate to 3.3% in 15 months. On average since 1969, the unemployment rate trough occurred nine months before the National Bureau of Economic Research (NBER) determined that a recession had started with a maximum lead time is 16 months. Interestingly, the same time distance is observable for the yield curve. We are probably years away from a recession. It's far more likely that we are going to get a healthy slowdown and avoid unstable imbalances.

What's Going on Right Now: Canada

Canadian economic data points like the trade balance, perhaps surprisingly, are very encouraging. I've upped my estimated growth for the second quarter to 3.0% suggesting that the Bank of Canada will hike rates at the next meeting in September.

Take note that there is a lot of speculative short positions on the Loonie in forex market, probably stemming from instructions by the Saudi central bank and state pension funds to dispose of Canadian equities, bonds and cash holdings regardless of the cost. On Thursday morning, the Canadian dollar was 76.75 US cents, that's about 3.25 US cents less than it should be and down from a February high of 81.50 US cents. This could be a cheap entry fee to chip away at the Loonie, especially if one believes that a NAFTA deal is in the making.

Incidentally, the geopolitical dispute between Saudi Arabia and Canada over issues of human rights illustrate the need for more Canadian pipelines to improve energy security. The assurances given by the Saudis as the world's largest oil exporters that petroleum supplies to Canada will continue does not give, in the opinion of many Canadians including the Canadian Association of Petroleum Producers, enough "firm and long-standing confidence." Statistics Canada reported that Canada imported about C$1.2 billion worth of oil and fuels from Saudi Arabia in Q2. If Canada is going to interfere in the internal affairs of other countries, it should do it from a secured position of strength.

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

1. Based on the Dow Theory, the trend for that S&P 500 is bullish with key resistance at 2872 and key support at 2750 —2859.
2. Based on a proprietary model, the trend for Crude Oil is bullish with key resistance at $74.21 and key support at 64.34 — $67.16.
3. Based on another proprietary model, the trend for Gold is neutral with key resistance at $1268 and key support at $1173 — $1223.
4. Based on a proprietary model, the trend for 10-year treasury yields is bullish with key resistance at 3.11% and key support at 2.87% — 2.97%

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