Issue 33

PALOS

August 16, 2018

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Getting Income in the Marijuana Space

The marijuana business is still in its infancy, and many Canadian companies are ramping up production and innovating new products for the medical and recreational markets. According to CIBC, the Canadian market opportunity could be as big as $6.5 billion by 2020. The legalization of recreational marijuana usage will occur on October 17, 2018.

The real opportunity is in the United States. The issue that the industry is facing in the U.S. is that recreational consumption is legal in some states and illegal in others. Recreational consumption remains federally illegal. However, in June 2018, a bill called The STATES Act was introduced to the U.S. senate. The act aims to amend the Controlled Substance Act to exempt marijuana activity that is legal at the state level. If this bill moves forward, this could effectively make marijuana legal federally at the state level where it’s already legal. The US market could be 10 times the size of Canada, and it’s already the potential size of the Canadian market in states where medical and recreational cannabis are legal.

On August 15, 2018, Constellation Brands Inc (NYSE: STZ) announced that they would invest $5.1B in Canopy Growth (TSX: WEED) at $48.60 which represented a 50% premium to Tuesday’s close of $32.15. The transaction brings STZ ownership of WEED up to 38%. STZ is preparing itself for global legalization of recreational marijuana. A $5.1 billion cheque reaffirms the seriousness and opportunity of the new market.

On June 15, 2018, WEED issued $500 million of 4.25% convertible senior notes due in 2023. The conversion price is $48.18 per common share which is below the $48.60 at which STZ invested its $5 billion. The funds invested in the convert at issuance as I thought it was great way to get exposure to the marijuana industry. The funds collect income while being exposed to the industry’s upside. Furthermore, with this new $5 billion cash injection the credit of WEED has significantly improved.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.56	-1.62%
Palos Equity Income Fund - RRSP	PAL 101	$6.34	-2.18%
Palos Merchant Fund L.P. (Mar 31, 2018)	PAL 500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL200	$8.45	-21.05%
S&P TSX Composite			1.88%
S&P 500			7.55%
S&P TSX Venture			-20.76%

Chart 2: Market Data*

	Value
US Government 10-Year	2.87%
Canadian Government 10-Year	2.26%
Crude Oil Spot	US $65.46
Gold Spot	US $1,176.20
US Gov't10-Year/Moody BAA Corp. Spread	190 bps
USD/CAD Exchange Rate Spot	US $0.7600

* Period ending Aug 16, 2018

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■ Mendel's Option Corner

By Robert Mendel

When it comes to options people often ask me why I am so smart. It's because I used to be so dumb, it's as simple as that. And a stock called Doubleclick from 15 years ago was my biggest stupidity.

The discipline I have and rules I now live are because of that one mistake. The details will be in my book, but essentially, I was selling puts at $90 and it was finally taken over by Google at $10. A nice play for sure.

Let me give you an update on my Netflix play. If you remember, I was short the July 395 puts going into earnings and had to subsequently rollover to August since the stock sold off. Now I've had to roll once again and did so to the October 395s for a further $3.60 credit. My total credit received is $24.15 so my break-even on the stock is now $370.85 (as I write this it is at $328). So I wait once more but at least I lowered my cost. Will keep you posted.

I have never really liked Gold but it has sold off maybe a little too much in the short term, so I will look at some things and report back if I initiate any positions.

Until next week.

■ What is New on the Macro Level?

By Hubert Marleau

The Dollar Shortage and King Dollar

The U.S. dollar is the hyper-dominant global currency, making the Federal Reserve Bank the effective world central bank in a highly globalized financial system. International market forces are deeply intertwined, and global dollar flows competitively provide liquidity. In a convincing book named "How a Decade of Financial Crisis Changed the World" Adam Tooze eloquently explains how the crash of 2008 initiated the wave of nationalism, protectionism and populism producing consequential results in the global economic and monetary orders today. A wholesale shift is going on in geopolitical alignments, international trade, technological applications, political systems, and in the operation of the monetary system. Donald Trump is the critical figure marking the end of the post-war era and the start of this new one. The U.S. Department of Defense publishes a report on the ideal national defense strategy every year. The December 2017 report is a road map for the new era. It clearly spells out that "a long-term strategic competition requires a seamless integration of multiple elements of national power: diplomacy, information, economics, finance, intelligence, law enforcement and military." Given this belief that there is a re-emergence of long-term. strategic competition between nations, national security boundaries are driving economic and trade policy. There is a feeling that the U.S. needs to respond to the long-term planning of strategic competitors like China which incidentally has a 2025 plan. It explains why we are seeing more protectionism, sanctions, and other disruptive approaches to trade policy.

To achieve success, the U.S. dollar needed to be cheap for it would be the easiest way to win a trade war. A cheap currency makes export goods so competitive that the other side wants a deal badly. From the get go in November 2016, the idea was to get the DXY dollar index, a popular trading unit that compares the US dollar to a basket of its major trading partners in the developed world, to perhaps as low as 85. In January 2018, the dollar index was near that objective for it was trading around 89. Unfortunately for Trump, the plan did not pan-out. On the contrary, over the past 8 months the greenback rallied all the way to 97 with 103 being considered by some as a critical tipping point for the Fed. Incidentally, there have been few clues about the pace of further Federal Reserve rate hikes and no rhetorical interventions. Nevertheless, the dollar has climbed higher without having to lift a finger.

Consequently, there have not been any trade deals so far because the price of dollar is too high to harm the export sectors of U.S. trading partners. The dollar is key for it is dominant. Firstly, in the $5.1 trillion-a-day foreign-exchange market, the U.S. dollar is on one side of 88% of all trades, according to the Bank of International Settlements (BIS). Secondly, the dollar weight in foreign-exchange reserves accounts for 62.5% of the $10.4 trillion in allocated reserves identified by the International monetary Fund (IMF). Thirdly, U.S. capital market is the biggest, the most liquid and the broadest in the world, making the dollar the most attractive to companies and governments looking to raise money and to investors with money to put to work. Consequently, currency traders are enforcers in the financial market for they can force discipline or imposed their will on a as need be basis.

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What we currently have is an oddity of sorts in the marketplace. On the one hand, we have a U.S. central bank wishing to impose a tighter monetary policy with rate hikes while applying Quantitative Tightening (QT) to fight growing inflationary pressure. On the other hand, there's a U.S. administration that openly prefers a weaker dollar. The oddity is that much of the uncertainty about global growth generated by unorthodox U.S. policies on tax, trade, sanctions, climate change and political alliances have lured investors to the U.S. keeping the dollar strong. The point is that U.S. monetary policy and disruptive actions are having the opposite effect to that which Trump aspires. In this regard, I strongly suspect that the Fed and the Treasury may put in place measures to steer the dollar's path and change the dynamics of the dollar's liquidity. On several occasions in the past, the U.S. has pulled surprises when it came to dealing with its currency problems. It may intervene again. Currently, we have a global dollar shortage. Currency traders are awakening to the reality that President Trump may follow through on his jawboning, with potential implications for the independence of the Fed. History shows that the Fed usually falls in line and plays its usual role of following the Treasury's lead on dollar policy. It should be noted that currency intervention does not necessarily impact monetary policy, since the Fed can sterilize the selling of dollars by purchasing an offsetting amount of U.S. securities at home, thus leaving the monetary base unchanged. The bond market does not pay much attention to the US monetary base, focusing more on the price of money as in consumer prices and not the quantum of money like the monetary base. Currently, the latter is rising while the former is declining. The implication is that U.S. protectionism is short-term inflationary but long-term deflationary. It explains the narrowing of the yield curve. Two-year bond yields (2.65%) are responding to rising inflation while ten-year bond yields (2.90%) anticipate slowing growth. Therefore, one needs to closely monitor the US monetary base and foreign dollar reserves in relation to the dollar index in addition to regular data points. Currency is in one way an awesome leading indicator; the performance of the dollar represents either an expansion or a contraction in the pool of U.S. money needed for international trade to flourish.

The primary cause of the dollar shortage is the contraction in World Monetary Base (WMB). A contraction leads to weaker world growth and a stronger U.S. dollar at the same time. WMB consists of the US monetary base plus securities held by the Fed for foreign official and international accounts. The U.S. may have to game this out or stumble into a trap of having an ever-higher dollar creating ever more disinflationary uncertainty. To that end, the Fed may decide to inject some high-powered money to match the foreign central banks' dollar purchases. The dollar's performance in the second half of 2018 could then be less disruptive as a good deal of the divergence between growth and policy in Europe and U.S. is probably baked into the current price. Understanding the scale of U.S. borrowing stemming from tax cuts, the truth behind the attempts to win a trade war, and the root driver of core inflation, the state of splendid isolation from the rest of the world will not last forever. If you are bullish on the U.S. dollar, you're not alone, it's a very crowded trade. Yet, it is unnatural to have a rising currency combined with depressed long-term bond yields, rising core inflation, and falling gold prices. Many insiders are aware that the ratcheting up protectionist measures is the root cause for this unnatural process and the asymmetry in the crowded consensus. One does not have to go too far to realize that the underlying cause of the uniform fall in a wide range of emerging currencies is the dollar. The clearest indication comes from gold. Gold prices are a gauge of the perception of inflation risk, alarm about the Fed, and fear of currency debasement. Measured in dollar terms, the price gold is down 12.5% from a year ago. It boils down to the belief that the fed is way too hawkish, thus producing the strong dollar. In this connection, I expect cracks to open up soon suggesting that rotation from cash into cheap inflationary products may be a good calculated risk. The rising value of the dollar is tightening financial conditions beyond the intention of the Fed. The Goldman Financial Condition Index (GFCI) calculates that of the five factors that determine financial conditions, the DXY, a trade weighted dollar index, accounts for 75% of the present tightness of financial conditions. This is certainly helping the Fed to keep a lid on inflation. The other four factors are credit spreads, ten-year treasury yields, the federal funds rate, and the S&P 500.

There are five influencing factors supporting reasons some exposure to the reflation idea. Firstly, foreign investors are piling into China's $12 trillion bond market despite a tumbling yuan and a narrowing gap between Chinese and U.S. interest rates. Foreigners' holdings of yuan-denominated bonds hit a record 1.35 trillion yuan in July for a 61% year over year increase. Second, a growing number of countries, fearing intensification of U.S. sanctions and the

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imposition of U.S. tariffs and quotas, are cutting dependence on the dollar for they believe that the US currency is becoming a risky instrument in international settlements. Thirdly, the Fed could pause rate hikes while the BOJ, ECB BOE and BOC introduce tighter monetary stances to rebalance. Fourthly, the U.S. could strike a trading deal with Mexico. Five, the U.S. Treasury could use the Exchange Stabilization Fund to sell dollars. Six, the Fed could either downsize or suspend its tapering program.

That being said an overweight position in defensive stocks is still the order of the day for the above points are only potentially on the come.

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

Recently released economic data points that feed high frequency economic models are off to good starts. The Atlanta Fed's GDPNow model's estimate for real GDP Growth in the third quarter of 2018 is 4.3%. The NFIB small business report continues to surprise to the upside. The overall Small Business Optimism Index hit the highest level (107.9) since 1983 in July. Moreover, the Cleveland Fed's Inflation Nowcasting model predicts that Core PCE inflation will run at the annual rate of 2.03% for the comparable period. Interestingly, for all the talk about tight labour markets pushing up wage growth, U.S. households don't see it that way. The latest survey from the NY Fed show that one-year-ahead earning growth expectations are only 2.0% and overall household income growth expectations are 2.5%. The big explanations for this surprise are the growing share of old people in the workforce and the decline in necessity prices. In fact, the NFIB also reported no acceleration in selling prices suggesting limited upside risk to core inflation with little evidence of wage growth. The Bureau of Labor reported on Wednesday that productivity growth perked up in the second quarter to an annualized rate of 2.9% confirming that the productivity trend is firming up and that unit-labour cost in contained. Unit labour costs, a good predictor of inflation, decreased 0.9% at an annualized rate of 0.9% in the second quarter. Preliminary indicators suggest that the productivity momentum is carrying into the third quarter.

Meanwhile, the consensus for 2019 S&P 500 EPS is holding well at $177.00. In this connection, valuations are reasonable while economic growth is solid and inflation is relatively stable. Stocks are trading at 16X next year's earning. The Rule of 20, the Fed Model, the Misery Index and Earning Spreads are also supportive that the bull market could potentially continue for years.

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 2891 and key support at 2750 —2834.
2. Based on a proprietary model, the trend for Crude Oil is bullish with key resistance at $72.78 and key support at 64.22 — $64.94.
3. Based on another proprietary model, the trend for Gold is neutral with key resistance at $1268 and key support at $1173 — $1186.
4. Based on a proprietary model, the trend for 10-year treasury yields is bullish with key resistance at 3.06% and key support at 2.72% — 2.85%

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