Issue 43

PALOS

October 25, 2018

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

The Government Considering a Band-Aid on Oil Differential

The Alberta Premier, Rachel Notley, is making a lot of noise and for good reason. She is proposing to Ottawa to put a Band-Aid on the injury that they self-inflicted. The Premier is pushing Ottawa to consider crude-by-rail business to alleviate some of the oil price differential issue.

In my view Ottawa has painted themselves into a corner and need to consider every option possible to alleviate this problem. Too much is at stake to be ignored. It has been over a decade that Canada been selling its energy to the US at the cheapest price on earth. Some studies are stating that the whole Canadian energy sector is losing $100 mil of revenue a day.

Who's losing? We are. Lower tax revenue for our federal government, lower royalty revenue for the province of Alberta. Don't forget our governments are running the books in the red. In addition, high paying jobs will disappear, and capital will continue to flee the country. It's just bad business.

If the premier is successful in convincing the Federal Government that something needs to be done in the short run, an Alberta rail terminal of significant size would help the situation and act as a Band-Aid until our government approves the building of pipelines that are in our national interest to export our oil to new markets. In the past, the Canadian government supported other industries like the auto industry in 2009. I don't

	Time	Price	Chg	Diff	Chg
Canada					
Edmonton Syncrude S...	11:01	40.07	+.25	-27.00	+.00
Edmonton Mixed Sweet	11:01	37.57	-.25	-29.50	-.50
Edmonton C5 Condens...	11:01	55.57	+.25	-11.50	+.00
West Canada Select (...	11:01	21.32	+.25	-45.75	+.00
Implied Bitumen	11:01	6.64	+.25	-60.43	-.05

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$8.68	-8.84%
Palos Equity Income Fund - RRSP	PAL101	$5.81	-8.86%
Palos Merchant Fund L.P. (Mar 31, 2018) [2]	PAL500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL210	$7.95	-26.36%
S&P TSX Composite (Total Return with dividends reinvested)			-5.79%
S&P 500 (Total Return with dividends reinvested)			0.88%
S&P TSX Venture (Total Return with dividends reinvested)			-24.41%

Chart 2: Market Data[1]	Value
US Government 10-Year	3.10%
Canadian Government 10-Year	2.44%
Crude Oil Spot	US $66.82
Gold Spot	US $1,238.60
US Gov't10-Year/Moody BAA Corp. Spread	196 bps
USD/CAD Exchange Rate Spot	US $0.7659

[1] Period ending Oct 24, 2018. Data extracted from Bloomberg
[2] Fund is priced annually

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see why they would not support our Canadian energy industry.

Either with or without Ottawa the rails are well positioned to help the energy industry. I'm of the opinion that many of the larger producers will sign deals with (TSX: CP) and (TSX: CNR). We have seen (TSX: CVE) sign a 100,000 BOE/D of heavy oil crude by rail and I believe it's only the beginning of such contracts. Unfortunately, only the large producers have the capability of signing such deals, as they have the production, the girth, and the capital to do so. Therefore, a government terminal is so important, so smaller producers can also get access to rail. Smaller producers don't have the size or the capital to sign long term agreement with the rail.

■ Mendel's Option Corner

By Robert Mendel

Since I have nothing funny to start off with I will jump right in.

Stocks continued their downward trend and, to me, looked to be approaching oversold territory, in the short term at least. With earnings and dividends in play I thought it was time to strike. This is what I did since last writing.

On Monday Oct 22nd, with Boeing trading at $356 and earnings set to be released before the market opened on the 24th, I sold an October 26 350 put for $5.65. I figured Boeing would continue to deliver strong earnings like it has been doing for the last several years. This equates to a 1.6% return in 4 days should it work (5.65/350) and with a little downside protection too.

On Tuesday Oct 23rd, I initiated a covered call play with an eye toward collecting dividends as well. I bought Royal Bank at $97.54 and sold the Oct 26 98 calls for .20 cents for a net debit of $97.34. The stock was set to trade x-dividend the next morning (today as I write this) for .98 cents. This means my cost would drop to $96.36 and if Royal happens to trade higher than $98 by Friday I would be walking away with 1.7% in 3 days, and I am ok with that. If it doesn't I will keep the stock and will look to sell another call again.

On Tuesday Oct 23rd , with Goldman Sachs trading at $216, I sold a November 23 207.5 put for $3.40 which equates to a 1.6% return in 31 days or a 18.8% annual return, and this with a 3.9% downside protection – mind you in this market it could breach it in 6 minutes.

On Tuesday Oct 23rd, with Federal Express also trading at $216, I sold a November 16 210 put for $4.90 which equates to a 2.3% return for 24 days or a 35.5% annual return. It comes with it a 3% downside protection which would take it below the 52-week low.

Will keep everybody informed on how it turns out.

As an update to Netflix last week, I mentioned how I was now in a better position to roll the short Oct 19 395 puts since the company reported better earnings and the stock rose to the $380 level. Well the good news couldn't keep the stock up and it proceeded to fall back to the $340 level making my roll to November 16 much less attractive. So, where I was hoping to pick up $10-15 for the month I ended up collecting only $3.90. Still it brought my total credit to $28.05 from $24 so not entirely terrible bringing my break-even to the $367 level (as I write this the stock is set to open at $335, so I am still down)

Got to go,

An addendum. I just pulled back this letter to write an update as I Just got my Royal Bank (mentioned above) taken away because of my short call. So I get no dividend but I end up selling the stock at $98 and making .66 cents (98-97.34) in the process after one day. I really wasn't expecting to be taken out, but it actually worked out for the better since the stock is down more today (as I write this it is $95.65) than the dividend would have paid me. Bottom line is I can buy the stock at cheaper levels right now. But I will wait a little.

■ What is New on the Macro Level?

By Hubert Marleau

What Is Going On Right Now:

By the time this is read, one will know for sure how the U.S. economy fared during the third quarter of 2018. According to the Atlanta Fed's NowGrowthCasting model, the economy grew at the annual rate of 3.9% and according to the Cleveland Fed's NowInflationCasting model, inflation ran at the annual pace of 2.1%. It means that N-GDP increased at the annual rate of 5.0%. Therefore, on a year-over-year basis, the estimated increased for N-GDP is 5.5%. Based on available data, inflation, employment and productivity accounted for 2.4%, 1.3% and 1.8% respectively of the overall yearly increase. What is remarkable is that the growth was generated

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without large increases in the money supply, suggesting improved velocity and more money heading into the real economy than into the complicated algorithmic and quantitative side of the financial markets.

There is a debate going on about whether this rise in velocity results from the U.S. issuing a lot of new debt to pay for the tax cuts while the Fed is unwinding its balance sheet rather than the reduced use of bank credit to purchase interest-sensitive items such as durable goods and residential homes. I don't know which of the two is the main cause. Suffice to say that it could also be related to a close relationship between money turnover and productivity. Strangely, very few market analysts seem to attach any importance to the surge in productivity. It's as if there has not been any. Yet, increases in productivity have gone up steadily from zero in 2015 to an estimated rise of 1.8% in Q/3 of 2018. It explains why unit labour costs have hardly risen and neither has core inflation because productivity has put a lid on wage gains. Moreover, Moody Analytics estimates that the chance of a recession occurring in the next six month is only 10%. It should be noted that bear markets occur when a recession is on.

What's the Outlook---It Boils Down To What Will the Fed Do

We just had a perfect storm of bearish technical factors which has brought about a serious correction. In just one month, the S&P 500 index is down 6.8%, the Equity Risk Premium (ERP) rose from 225 to 305 bps, the S&P 500 P/E multiple decreased from 18.25x to 16.30x. The rule of 20 (Forward P/E plus Core Inflation) is 16.30, is low enough to consider the market as a buy. The bearish conditions like the sudden rise in bond yields, trade wars and changing market sentiment concerning valuations were too much for the equity market to absorb even though earnings kept going up. In this connection, the Federal Reserve will need to dial back its plan to raise the policy rate another five times, President Trump will have to de-escalate his trade disputes with the EU and Japan and growth and inflation will need to settle in a sustainable manner around an annual rate of 2.25% and 2.00%, respectively, if the equity markets are to regain its footing.

Technically, there should be another long leg to this bull market. But first, the current correction in US equities needs to adjust to the new cost of capital to establish a bottom. It may have already happened for private clients at BofAML are holding a near record high 3.0% of their margin debt in Treasury Bills. In other words, well covered with cash ammunition to buy dips. Additionally, as revealed by the St Louis Fed stress index, the financial system is not as easy as it was a year ago, yet credit conditions are still accommodative. Put simply, the recession risk is very low even though a growth slowdown is in the offing.

The problem is that there has been too much leadership concentrated on the momentum/growth side of the equation and not enough on the value side. This too will have to change if we are going to get that last bull leg. Market history shows that last bull legs can last as long as 3 to 5 years. I'm maintaining a constructive outlook for the year ahead. Yes, there are still many crowded trades like net long positions in FAANGs and U.S. dollar and net short exposure in U.S. Treasuries. They could easily unwind to change into beaten down value stocks, especially if the winds were to change direction. It's my view that the economy should slow down to a more sustainable level in terms of inflation and growth. If the latter pans out, the dynamics of the past several years could go in reverse. S&P 500 valuation metrics are amplified by the crowded momentum/growth names. Should these hot stocks really start to underperform in a persistent manner, the cheapness of hard value investments would also start to show up in their price multiples to sales, book values and earnings.

If trade negotiations between the US and the EU and Japan turn into agreements that resemble the USMCA, then the stock and bond markets would become a function of whether the Federal Reserve will respond responsibly to the prospective slowdown in economic growth and the rate of inflation. In my judgement, the Federal Reserve has generated enough tightening in financial conditions to slow the economy sooner rather than later, suggesting that it may not need to do more rate hikes than what those already priced in the yield curve. The current Fed policy is modestly accommodative, and we are within two quarter point hikes of achieving a neutral territory where it is neither stimulating nor restricting economic growth.

The point is that the Fed has basically met its dual mandate of full employment and 2% inflation. Expressed differently, the Fed's policy rate is starting to hurt the interest-sensitive sectors like motor vehicle sales, new and existing home sales and some of the cyclical sectors of the markets like the banks, industrials, energy and material

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stocks. These cyclical stocks have already seen near 20% corrections in their multiples since the S&P's valuation peak on December 18. 2017. The Fed also watches the barometer. And, Fed forecasts are mere projections, not promises. If the economy was to stumble, odds are high that the Fed would react appropriately.

Unfortunately, there is an exception to this rule - inflation. The real worrying should start when inflation is stirring. It is possible that the Phillips curve - the relationship between unemployment and inflation - may turn positive from seemingly flat. In the sixties, the relationship was also flat until the low unemployment and fiscal spending ramped up. The combination set in motion the inflation period of the 1970s because there was no productivity and labour slack to cushion the inflationary forces. Today the conditions are different. At this time, we are not at that point of inflection for two reasons, the employment/population ratio is much lower than back then, the labour force participation rate is considerably lower, and productivity is rising. The economy has a better buffer to combat inflationary pressures and so far, the thesis is holding. September data revealed another month of tamed inflation.

The point is that the economy at full employment has not acted as it has the past. I think that this phenomenon is connected to inequality and lower bargaining power. Available evidence supports that there is still significant slack remaining along with automation to keep wages in check. Firstly, this time there is an unusually large number of people who are not working or looking for work, so they are not counted as unemployed, but who can and do rejoin the labour force if they see the right opportunity. Among Americans of prime working age, 25 to 54, some 30 million are not working or actively looking for work but waiting just offstage. It explains why the labour force participation rate of prime-age workers is still way below its peak in the last expansion. Secondly, many are satisfied with working part-time for less pay or in the underground for cash payment. This allows flexibility, preferred hours and spare time. More importantly, many people are just underemployed. Companies are getting bigger and more powerful squeezing as much as they can out of workers' pay and forcing them into no-poaching agreements and non-compete clauses. This happens because labour-saving techniques exist, unions are weak and competition from lower-wage countries is about.

The fact is that the job market is not as free as commonly believed. Consolidation of businesses has left potential workers with fewer places to work, shifting the balance of power to employers. This is creating a situation that economists call "monopsony". Unlike monopoly, it affects input costs rather than output price. It's a concentration of business power that leads to anti-competitive behaviour which effectively holds down wages.

The Herfindahl-Hirschman Index (HHI) measures employer concentration. The index exceeds 2,500 in a majority of the country's commuting zones which accounts for almost 20% of total employment. Anything above 2,500 reflects concentration of employer power - monopsony. Census data concludes that monopsony exists where unions are weak, communities are small, businesses collude, and companies face foreign competition, suggesting that minimum wages are difficult to implement and can create fewer jobs. The record shows that monopsony affects both blue- and white-collar service workers. When one adds all of the other stuff like zoning rules, occupational licensing (barbers) and number requirements (1 in 5 jobs) that are not on the radar, many need to go underground to get work. Constraints leave many wages below those of a normal free market. It is inherently easier to buy a different brand of sodas than to get a different job. A soda is there for the taking, while a job requires the agreement of the parties.

Nevertheless, I'm suggesting a weighted position in gold as a defense against being on the wrong side. It affects beta performance, but it could prove to be good protection.

Bottom line: The Fed has the capacity and willingness to respond to threats to the economy, as long as inflation remains contained. History shows the Fed actually did so in late December 1965, March 1983 and February 1994. Then the monetary authorities changed the trajectory of the economy, ending up with a soft landing that keeps the economy afloat. The policy makers will not panic over inflation and allow the target rate to cross over the maximum neutral rate level (3.00%), if they do not need to. Absent of an inflation shock, you can bet your bottom dollar that is a "Powell Put" for the economy. What needs to be watched is whether a shocking input cost stemming from wages, tariffs and/or raw materials gets out of whack. It is not the case at this point in time.

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P.S. Beware of doomsday bloggers who have a tendency of becoming overnight experts when there is an acute selloff or sudden blow-up that needs some explanation. Such occurrences are usually connected to dynamic systematic/technical flows like rapid-fire option-gamma hedging, trend followers and volatility targeters that few people understand. It's more important to stick with fundamental economic and monetary factors like the ones that I display from to time to time on a "Recession Risk Dashboard" because the aforementioned factors get exhausted as demand from bargain hunters rise. Because my Economic, Stock and Bond Dashboards do not foresee a recession or a bear market on the horizon we should not be too concerned with the probable continuation of the push-pull dynamic that has characterized the stock market all year long.

On one side of the equation, we have buybacks and robust earnings that are bullish and on the other side, we have geopolitical issues and the Fed's monetary stance that are bearish. In my view, the latter side is weaker for I think that the U.S. will find a way to deal amicably with Japan and the E.U. on trade and the Fed will pause the tightening process in two hikes. The teeter-totter could be all over before the end of March of 2019. It's hilarious to think that Powell will cave in when he has already acknowledged that run-ups in the last recessions were related to destabilizing financial conditions. What we are getting is a market adjustment to a change in investment rotation, cost of capital and in the relationship between stocks and bonds. As a matter of fact, I would argue that the Fed has a real chance to achieve a soft landing because inflation has never been better anchored, allowing the Fed 1) to raise interest rates once per quarter, 2) enough time to continuously assess how past tightening is affecting the economy and 3) to reassure the market players that the monetary authorities are not in a rush.

What's the Deal Between the Stock Market and Recessions?

Next week, I will empirically demonstrate that the stock market does not anticipate recession and that bear markets starts when a recession starts. It is a false assumption that the stock market is a forward-looking recession indicator. It's a more of a coincident indicator. I will explain why in next week's commentary. Suffice to say that bear markets that arise out of a recession are deep and have long "L" recovery while those that are not and resemble corrections are fast and short and quickly correct in "V" shaped recoveries.

New Technical Perspectives as of October 25, 2018—Sevens Report

1) Based on the Dow Theory, the trend for that S&P 500 is bullish with key resistance at 2868 and key support at 2654 —2809 on Thursday morning, through key support. Should rebound.

2) Based on a proprietary model, the trend for Crude Oil is bullish with key resistance at $74.22 and key support at $65.44 —$66.68 on Thursday morning.

3) Based on another proprietary model, the trend for Gold is neutral with key resistance at $1256 and key support at $1187 — $1235 on Thursday morning. Could go to $1300

4) Based on a proprietary model, the trend for 10-year treasury yield is bullish with key resistance at 3.31% and key support at 3.00%---3.12% on Thursday morning, above the highest key resistance of 3.13%.

5) Based on a Palos Currency Model, the trend for the Canadian dollar turned mildly bullish again with key resistance at 79.75 us cents and key support at 75.26 us cents---76.63 us cents on Thursday morning. However, the tone of the Bank of Canada was too hard for an economy that is relatively weak compared to the U.S.

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