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Palos Weekly Commentary

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Macro View

By Hubert Marleau

The Weekly Narrative: Week Ended November 29, 2018:

What's Going to Happen Next?

It's hard to say because the future has a lot of ins, outs, and what-have-you. Many make bold forecasts with incredible confidence. I have a hard time with that. In investing, there are ways for investors to succeed and take advantage of complex situations to their advantages. I find that it's best to understand what is going on and make decisions on a rules-based approach which is supported by economic and financial history, empirical evidence and valid theories. Fear and greed induce errors.

Over the past two weeks, I wrote that the three big variables: inflation, employment, and productivity trends are positive. Yet, there are three main concerns that are haunting investors. These are the partially technical plunge in oil prices, the seemingly stressful financial conditions and the growing aggravation over the trade dispute between the U.S. and China. As a rule, both the bond and stocks markets tend to react violently to dramatic changes in oil prices, monetary policy and geopolitical trade shocks. Accordingly, investors, out of caution, have priced in a recession-like scenario, fearing a global growth slowdown. Hence the 10% correction. And, that is what is going on. Thankfully, these three concerns might, perhaps, be addressed successfully over the next two weeks.

1) On November 30th, a G-20 meeting will take place in Argentina. Over the coming weekend, Presidents Donald Trump and Xi Jinping are expected to have discussions on how to the ease the trade spat while Russia's Vladimir Putin will have an opportunity to speak with Saudi Crown Prince Mohammed bin Salman about their crude oil policy. The idea of multilateral cooperation is proving to be controversial. There were two major diplomatic clashes in 2018 - at the G-7 in June and at the Asia-Pacific Economic Cooperation summit in November. It's hard to believe that the leaders of the world top economies will not use the G-20 gathering to find common solutions to the world problems (Trade, Environment, International Security). However, there are broad philosophical differences between countries. Countries have opposing methods of governing, making many issues hard to reconcile. Some countries like Russia and China are government-centric while others like the U.S. and the E.U.

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are more market-centric. For example, China has a 2025 government plan to make China great again that is objectionable to the U.S.

2) On December 6, an OPEC meeting will take place. The meeting will certainly deal with how to cut oil production in order to stabilize plunging oil prices. According to experts in the field, OPEC and its allies need to cut the production of oil by at least 1.0 million barrels a day to alleviate the worldwide supply glut.

3) On December 18th, the FOMC will take place. The meeting will definitely deal with whether to halt the rise in interest rates, slow down its raising pace or keep the same pace. We have just received an idea that the tone and language are becoming dovish. On Tuesday Fed Vice Chairman Richard Clarida said: "I would not characterize my thinking as monetary policy on a preset course". Furthermore, three regional Federal Reserve Officials acknowledged economic weakness in various interest rate sensitive sectors such as housing, autos and business capital spending, but remained upbeat that the expansion will continue. On Wednesday, Fed Chairman Jerome Powell said: "Interest rates are just below a broad range of Fed's officials' estimates of a level considered neutral, a setting designed to neither speed nor slow growth". The stock market reaction was what one would have suspected under growth and stable inflation. The ratios of oil-to-copper, copper-to-gold and gold-to-palladium support that aforementioned conclusion.

I do not know how any of these meetings will unravel. However, I know that they will be important for the immediate perception for inflation, growth, and in turn, the short-term outlook for stock valuations and interest rates. Because there is a mechanistic relationship between recessions and bear stock markets and bull bond markets and that these two markets tend look ahead, the uncertainties are causing fatigue. It does not mean that all of these events will result in a recession. Indices used to evaluate recession risks are ok when it comes to make prediction six months in advance, but very bad at predicting them nine months or more before they actually arrive. At this time, there is no recession in sight. Odds that the U.S. will fall into a recession in the next year stands at 15%, according to Bloomberg's U.S. Recession Probability Forecast Index. Moody's Analytics and Morgan Stanley are clocking 11% and 15% respectively.

Nevertheless, investors should keep in mind that the markets and the economies are co-integrated and therefore prone to sharing similar trends. In the fullness of time, it is empirically true and theoretically valid that equity prices and interest rates tend to follow the general path of N-GDP. I do see the economy losing speed next year and in 2020. But, if productivity is going to pick up the challenge and move the economy forward in two-plus-two manner that is 2% for inflation and 2% for growth, then long term rates (3.07%) are where they should be between 2.75% and 3.25% and allow equity prices to broadly rise 10% from Wednesday's closing point. I note that Richard Clarida pointed out that recent gains in productivity explain why inflation is running at the Fed's target rate of 2% even though growth has been strong and the labour market is robust. The beauty of having rising productivity is that it permits demand for goods

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and services to exceed estimates of the economy's apparent capacity to produce these goods and services. Put simply, demand has not exceeded supply, hence mild price increases.

Interestingly, Morgan Stanley came out with a new forecast for 2019 and 2020, predicting that R-GDP growth will average around 2.0% for the next two years. It makes sense to me because the yield curve has been boxed in a flat zone since the beginning of July and the 4% annual pace of change in the money supply supports this view. While analysts have downgraded the 2019 earnings growth forecast, there is sufficient juice left in a two-plus-two economy to bring about a 9% increase in operating profits.

The Canada-U.S. Stock and Currency Differences:

Compared to the S&P 500, the TSX has lowest valuation in over 15 years. Currently, the Canadian price-to-earnings ratio is 13.0x vis-a-vis 15.25x for the U.S. - that's a 15% discount. Normally, the Canadian multiples trade at a 5% premium. The Canadian Equity Risk Premium is 4.75% compared to 3.00% for U.S.. While I respect that the 60% difference reflects the higher risk of the Canadian economy, by the same token it reflects the much greater potential for stock market returns. In my judgement, there are two structural reasons and one market explanation for the gap. First, Morneau should have cut the Canadian corporate tax rate to 20%. The U.S. corporate tax rate is 25.8%. Canada has always had 20% advantage – it's now gone. Second, residential construction accounts for 7.8% of GDP in Canada compared to 3.8% in the U.S.. Whereas, business capital spending is about 3.9% in Canada compared to 6.25% in the U.S.. Put simply, the Canadian and Provincial Governments are subsidizing non-productive housing assets at the expense of business investments - the main ingredient of productivity. Canadian productivity is going nowhere while U.S. productivity is running at the annual rate of almost 1.5%. These two structural factors are the main reasons for the fact that that the Purchasing Power Parity Rate (PPPR) is around 80 US cents. Third, the plunge in oil prices and landlocked oil explain the discounts in both the Value of the Loonie and the TSX.

The analysts at Capital Economics have calculated that for every $10-per-barrel fall in oil prices, the Canadian economy loses, on an annualized basis, about 0.5% in real growth - that does not take into consideration the $150 million of revenue that we are losing every day from enormous oil discounts, simply because governments cannot get their act together to put things right. BUT THERE IS HOPE. BLOOMBERG CARRIED A STORY THAT "Canadian Crude is starting to rebound from historic lows". Alberta is shipping more oil by rail. SINCE HITTING A RECORD LOW ON NOVEMBER 15, THE SPOT PRICE OF HEAVY WESTERN CANADA SELECT (WCS) HAS RISEN 35% or $4,50. The good thing about this news is that it's narrowing the gap between WCS and WTI oil prices, bringing some needed stability to the Canadian oil market. As a matter of fact, the NEB reported this morning that Canada's oil output is growing, and heavy oil sands crude is growing faster than expected. With some luck that OPEC and allies come up with a constructive plan in Vienna on December 6 to remove the oil glut, we could expect the Canadian energy to react positively and raised the relative

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value of the TSX and with it the Loonie. Additionally, the U.S. Energy Information Administration reported that total crude exports are rising to record levels. This rise is in exports may keep U.S. stockpiles in check. It may also explain why the price spread between Brent and WTI oil has narrowed.

History is clear that the sectors that perform well during late-cycle equity periods are Staples, Healthcare, Utilities, Energy and Industrials while Materials, Financials, Telecom, Discretionary and Info-Tech become draggers.

P.S. Incidentally, I just spotted a current study by GMP Richardson that is worthy of consideration. It essentially says with the aid of statistics since 1994, that the P/E of TSX is about two standard deviations cheaper than that of the S&P 500 and below its long-term historical mean. “Given the valuation gap and the fall in the Canadian dollar, Canada is starting to look rather compelling”. Interestingly, the past shows that such circumstances have brought about 20% stock market returns over a next two-year period. It’s a very similar conclusion to what I wrote last week. I’m glad that I’m not alone in this frame of mind.

New Technical Perspectives as of November 29, 2018—Sevens Report

1) Based on the Dow Theory, the trend for the S&P 500 is bullish with key resistance at 2774 and key support at 2501—on Thursday the S&P 500 was 2734

2) Based on a proprietary model, the trend for crude oil is neutral with key resistance at $57.03 and key support at $46.31——on Thursday morning crude traded around $51.08

3) Based on a proprietary model, the trend for gold is neutral with key resistance at $1290 and key support at $1181——-on Thursday morning gold was selling for $1226.

4) Based on a proprietary model, the trend for ten-year treasury yield is bullish with key resistance at 3.23% and key support at 2.94% ——on Thursday morning the yield was 3.02%.

5) Based on a Palos Currency Model, the trend for the Canadian dollar is neutral with resistance at $76.23 us cents and key support at $75.01 us cents——-on Thursday noon the loonie was trading for $75.41.

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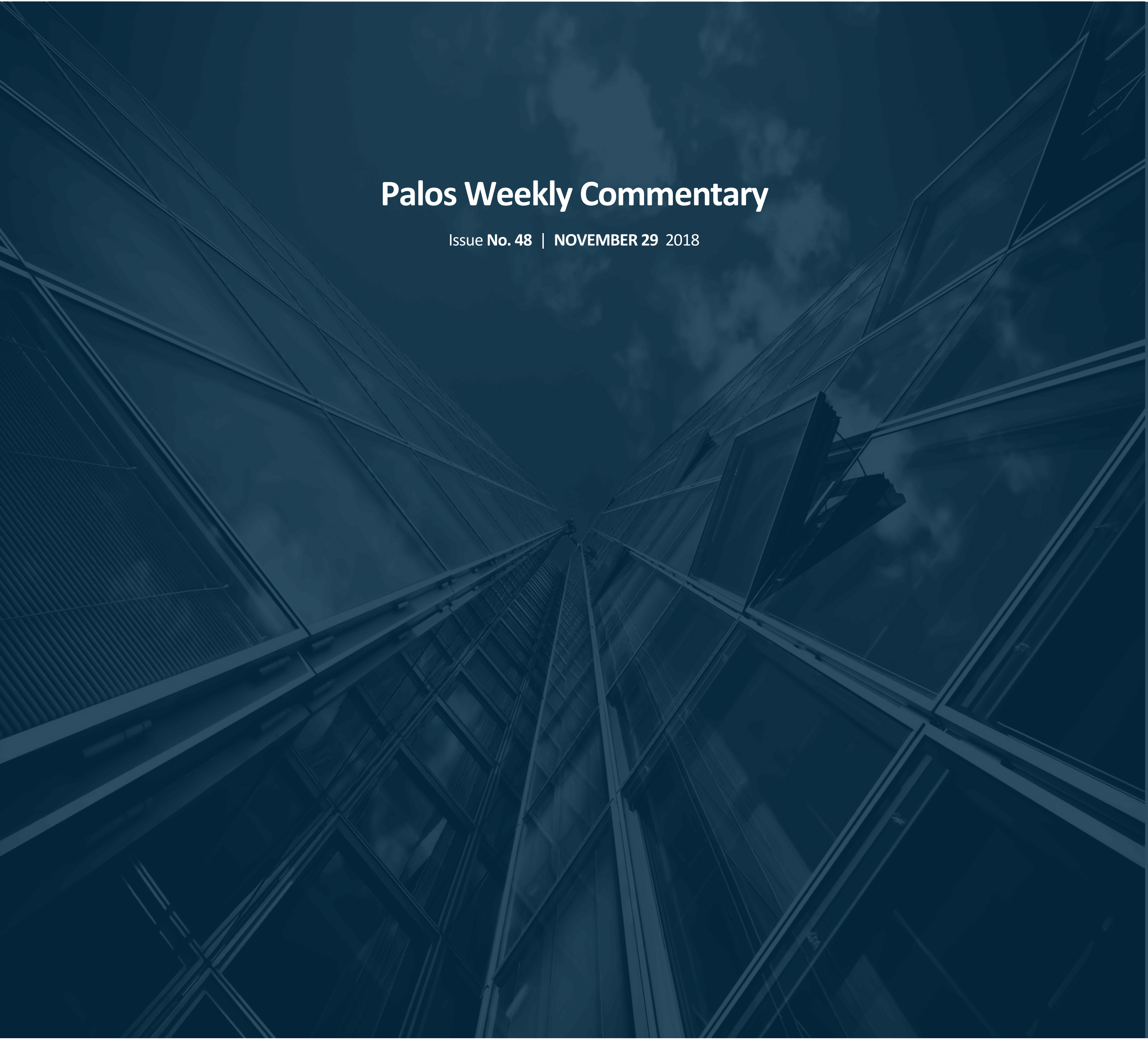

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