Issue 47

PALOS

November 22, 2018

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

2019 Probability of Rate Increases Is Falling

The market is now pricing in a 35% probability of two rate hikes in 2019. This is down from 57% a few weeks ago. There is good chance that the December rate increase could be the last one for a while. On December 19th, 2018, I'm of the opinion that the FOMC tone will be more dovish than hawkish, which leads me to be bullish but conscious on interest rate sensitive assets like Utilities, Energy infrastructure, telcos, real estate or companies that are asset heavy. The funds are well position to take advantage of this change in interest rate sentiment. Here are a few of the fund's asset heavy holdings and their dividend yield:

Company	Ticker (TSX)	Dividend Yield
Inter Pipeline Ltd	IPL	7.65%
Northland Power Inc	NPI	5.51%
Algonquin Power & Utilities	AQN	4.91%
Superior Plus Corporation	SPB	6.88%
Park Lawn Corp	PLC	2.11%
StorageVault Canada Inc	SVI	0.39%
Keyera Corp	KEY	6.13%
Sienna Senior Living Inc	SIA	5.55%
Pembina Pipeline Corp	PPL	5.12%
K-bro linen Inc	KBL	3.47%
InterRent Real Estate Investment Trust	IIP-U	2.31%

I believe there is a structural change taking place, and investors should start allocating investments in value and interest rate sensitive investments since yield appetite gain momentum as fear of rate increases fear dissipates.

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$8.52	-10.53%
Palos Equity Income Fund - RRSP	PAL101	$5.70	-10.55%
Palos Merchant Fund L.P. (Mar 31, 2018) [2]	PAL500	$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL210	$7.62	-29.36%
S&P TSX Composite (Total Return with dividends reinvested)			-4.45%
S&P 500 (Total Return with dividends reinvested)			0.84%
S&P TSX Venture (Total Return with dividends reinvested)			-28.85%

Chart 2: Market Data [1]	Value
US Government 10-Year	3.06%
Canadian Government 10-Year	2.36%
Crude Oil Spot	US $54.63
Gold Spot	US $1,227.90
US Gov't10-Year/Moody BAA Corp. Spread	217 bps
USD/CAD Exchange Rate Spot	US $0.7558

[1] Period ending Nov 21, 2018. Data extracted from Bloomberg

[2] Fund is priced annually

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■ Mendel's Option Corner

By Robert Mendel

For those of you who went out to buy a dishwasher like I had asked in issue 42, thank you. It helped. On November 15, a day before expiry and with the stock at $112, I rolled my short Whirlpool 120 put to the January 18 120s and collected an additional $1.90 bringing my total premium received to $5.80. And even though I have to wait until January, the stock is now back to $119 so I am in the black. I bet not too many people can say that these days!

Let me tell you about a new short call position I put on, bringing my short call plays to 3 (Telsa Jan 400 at $7.23 (issue 32) and Lululemon December 150s at $6.76). On November 15 with the stock at $68, I sold the USD$ Canada Goose January 75 calls for $3.10. My thinking here was the same as the short Lululemon call – that valuations were way too high for some of these clothing companies and it was really only a matter of time before it would return to somewhat normalcy, although who can really tell what normalcy these days is (besides, my wife hadn't shopped there for a bit so I knew the revenues would be lower). Anyway, I also did not want to get too much in the way of momentum, so I sold an out of the money call giving me some room if I was wrong. The strike was also over the 52-week high which gave me added comfort. If right, it would equate to a 4.1% return in 2 months.

An update on General Mills (issue 39). The November 45 covered call expired worthless on Friday the 16th since the stock finished at $44.50. So now I was left with the stock and since I wanted to re-hedge, I sold a December 45 call for $1.16 on Monday the 19th lowering my cost to $41.97.

An update on the Fed-X short 210 November put (issue 43): it expired worthless, a win!

I have nothing else to say…Enjoy Thanksgiving

■ What is New on the Macro Level?

By Hubert Marleau

The Weekly Narrative: Week Ended November 22nd, 2018:

The Monetary Stance of the Federal Reserve Is Bound to Pause in 2019.

In recent days, the monetary authorities have signaled that they intend to proceed with another quarter percentage point hike in their benchmark rate when they meet on December 19th. However, the will to continue the normalization process is very uncertain because the outlook for growth and inflation is rapidly changing and the financial and monetary conditions are more stressful than they have been for some time. It appears that the Fed is starting to get the market message and that it should act accordingly.

Indeed, why not pause the rate hikes and assess how the economy is responding so far? In my judgment, the plunge in stock prices, especially the cyclical ones, suggests that the economy may not be as strong as generally perceived. Acknowledging that the economy has largely hit both employment and inflation targets, Fed Vice Chairman is probably right that by some estimates the current policy of 2.25% is close to the neutral rate. I think that the neutral is 2.50%. If the economy is where it ought to be - that is neither too hot nor too cold - then stop raising the cost of capital. Moreover, there are a few more points that support my argument.

1. The October's core CPI was up 2.1%, showing that rising wages are not putting upward pressure on price inflation. This suggests that productivity is making a comeback and that falling oil prices will take some pressure off the headline inflation rates. The Cleveland Fed's NowInflation Casting Model is presently predicting that the Core PCE deflator will run at the annual rate of 1.8% during the 4/Q.

2. Cyclical expenditures that are interest rate sensitive such as business investments, residential construction, and durable goods, have either peaked or are rolling over, suggesting that the

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five hikes since December 2015 are starting to take toll on growth. The Atlanta Fed's GDPNow Casting model is pointing to a 2.5% annual growth rate for Q/4.

3. The four major Financial Condition Indices that are designed to measure how stressed the financial markets are and that takes into consideration factors like credit spreads, money supply, bond yields, equity valuations and currency movements are mildly restrictive and, in turn, not supportive of either growth or inflation. In other words, the economy is on its own.

4. Yet, the recession risk is still low and manageable. Moody's Analytics reported in November that the chance of having a recession over the next six months is 11%, up from 10% last month. Recessions occur when the risk is around 65%. The outlook for the U.S. economy is basically positive. The Conference Board's leading economic index rose 0.1% in October, in line with consensus expectations. All but three of the index's components were positive. It's not unusual to have a few negative components.

5. At the time of writing, the policy rate (2.25%) was 25 bps below my estimated neutral rate and the yield curve (10-year bond minus 3-month treasury yields) was 75 bps - far away from inversion, the credit spreads outside the oil sector are holding and short-term real rates were flat.

6. It appears that the U.S. economy is going back to a two-plus-plus pattern. That is 2% for inflation and 2% for growth under the context of full employment. In this connection, yields on ten-year treasury bonds should trade between 2.75% and 3.25%. This morning they were settling for 3.05%.

A few days ago, Chairman Powell declared that the Fed will conduct an extensive review in 2019 of how the monetary authorities guide the U.S. economy as the Fed seeks to become more open and accountable. The Fed will hold a series of forums across the country to hear from a wide range of stakeholders. By the time the review wraps up around mid-2019, it could introduce new tools to achieve the goal of price stability and full employment. Numerous contributors and participants think that we are in an opportune time to pause and wait until the review is over because the way monetary policy is formulated, conducted and communicate may change.

The Canadian Budget:

Finance Minister Bill Morneau unveiled on Wednesday $14 billion in economic measures to spur lackluster business investments and counter the risk of lost investments to the U.S. He acknowledged that the overall tax advantage that Canada had built over the last decade was lost and had to be addressed. To date, business investments have been lackluster, with growth decelerating in Q/2 to an annualized rate of 1.5%. Spending in 2017 machinery and equipment reached $297 billion, down 7% from the outlays of 2014. Moreover, the Bank of Canada estimated that the U.S. tax reform would have shaved 0.7% from the level of business investment and 0.6% from exports until the end of 2020.

Canadian firms will be able to immediately and fully write off the cost of machinery and equipment used in the production of goods. Businesses will be allowed to increase deductions on the purchase of computers, software, trucks and bulldozers. Additionally, there are no tariffs on the imports of machinery and equipment.

The Government of Canada announced that it would enact regulatory reforms to reduce red tape.

While Alberta's oil sector will profit from these broad measures, there were no specific concessions to the sector other than an acceleration in depreciation allowance for pipeline investments from 4.0% to 12.0%. It's UNFORTUNATE because there is a rising degree of frustration in Alberta. This is bad for the unity of the country. Yet, it is rumored that the Canadian government is considering a request from Alberta to share the cost of buying rail cars to move an additional 120,000 barrels a day of crude oil. The 120,000 barrels would cover most of the oversupply. In my

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judgement, the Trudeau Government has no choice but to find solutions for the made-in-Canada discount. Western Canada Select crude - the main blend sold by the nation's prolific oil sands - closed at $18.73 a barrel.

The Canadian Stock Market Is a Bargain:

The Canadian stock market is VERY CHEAP vis-a-vis the U.S. market. Currently, the Equity Risk Premium (ERP) for the TSX is 4.62% compared to 2.16% for the S&P 500. Put simply, it means that Canadian stocks are selling for a DISCOUNT OF 45%. Presently, the TSX adjusted for the exchange rate is 4.3 times the S&P 500. Historically, the aforementioned ratio has been 6.0 times and there have been periods when the ratio was as high as 12.5 times. I'm fully aware that investment conditions differ from period to period, but this calculation suggests that the Canadian stock market is selling for a DISCOUNT of 30%.

It should be noted that Brian Belski, chief investment strategist at BMO Capital Markets, has a year-end target for the S&P/TSX Composite Index of 17600 - that's 16% above the current level.

New Technical Perspectives as of November 22, 2018—Sevens Report

1) Based on the Dow Theory, the trend for the S&P 500 is bullish with key resistance at 2807 and key support at 2641 - on Wednesday evening the S&P 500 was 2650.

2) Based on a proprietary model, the trend for crude oil is neutral with key resistance at $61.37 and key support at $52.57 - on Thursday noon crude traded around $54.00.

3) Based on a proprietary model, the trend for gold is neutral with key resistance at $1256 and key support at $1181 - on Thursday noon gold was selling for $1228.

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 Wednesday evening 3.05%.

5) Based on a Palos Currency Model, the trend for the Canadian dollar is neutral with resistance at 77.75 us cents and key support at 75.15 us cents - on Thursday noon the loonie was trading for $75.82.

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