PALOS

The Palos - Mitchell Report

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Portfolio Manager and Equities Strategist

CONTENTS

The Markets - November

After climbing to new highs in early October, U.S. indices made an abrupt turn and swiftly headed south. In the final week of October, markets bottomed and staged a strong *Hallowe'en Rally* that ran out of steam in the second week of November. By U.S. Thanksgiving, the markets were testing the late October low with the Dow Jones Industrials, S&P 500, and NASDAQ Composite all negative for the year.

On November 28th, Fed chairman Powell's comments on interest rate normalization were interpreted as *'dovish'* by the street. This was perceived as a possible change in tune for interest rate policy. The ensuing rally was sharp and broad-based with the Dow rocketing over 600 points, or 2.5%. In tandem, the S&P 500 was up 2.3% and the NASDAQ up 2.9%. The TSX was up 1.5%.

In Canada, the 52-week high was established on Friday July 13th where the TSX Composite peaked at 16,561. With the subsequent global sell-off and a November 30th close of 15,197, the TSX Composite is showing a decline of 6.24 % for the year. This has been disappointing for investors, as we find the TSX at approximately the same level as Q4 of 2016. If there is any *'silver lining'*, it's the fact that the TSX had marginally outperformed the U.S. in recent weeks.

International markets have been even weaker than their North American counterparts. As of Friday's close, the STOXX Euro 50 Price Index (Europe) was down 7.67%, the Nikkei 225 (Japan) down 4.91%, and the Shanghai Composite (China) down a whopping 21.74% year-to-date. In the case of China, it's become increasingly clear that the *'trade war'* with the U.S. is taking a toll. Truth is, it's taking a toll globally.

Trump and Xi Jinping at the G20

The 2018 G20 Leaders' Summit was held in Argentina on November 30th and December 1st. Market attention was centered around the face-to-face meeting between Trump and Xi Jinping of China. Market observers were looking for any narrative on which direction Trump would embrace; a hardening or softening of his stance vis-a-vis tariffs on China.

Business leaders in North America have voiced their concerns that the 10 percent tariff was having a significant impact on costs. Ultimately, increased costs translate to lower earnings and slower growth for businesses, increased prices for consumers, or a blend of the two. Consensus is that a tariff increase to 25 percent would have an even greater impact on economic growth, jobs, and consumers.

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By the G20 close, headlines from the Summit were pointing to a 90-day truce whereby Trump would refrain from implementing his 25 percent hike on January 1st. While this was welcomed as positive news, the reality is Trump's threat has simply been *'kicked down the road.'* The matter is far from being resolved. Markets will now shift their attention into the first quarter of 2019, when the 90-day extension is slated to expire. More uncertainty on the horizon.

Oil Update

The swoon in oil that began in the first week of October has continued through November. When U.S. crude broke above $76/barrel on October 3rd, it was the highest price since Q4 of 2014. The bulls were running, and analysts' calls for *'one-hundred-dollar oil'* abounded. Fast forward eight weeks and it's become clear that the crowd was wrong - a cruel reminder of how quickly things can change.

So, what's behind the vicious sell-off? Speculators have floated various theories, among them forced liquidations, stressed hedge funds and speculation that Saudi Arabia is opening the taps to appease Trump. We know with some certainty that U.S. backed sanctions against Iraq were not as severe as anticipated. As a result, significant Iranian production is still flowing to market. Some have suggested that slowing growth is softening demand while others point to record production boosting supply. All the above are plausible.

The recent collapse in oil has been one of the most vicious on record and the *'oil trade'* has been difficult to weather. In times like this, it's critically important to remember the following. From an ***expectations*** perspective, it's important to accept that market fluctuations and volatility spikes are normal course behaviour. In fact, this should be ***expected***.

From a ***behavioura***l perspective, it's important to remain ***disciplined*** and ***rational***. By disciplined, we mean sticking to the game plan and recognizing that selling at a low point is destructive. By rational, we mean having the ***experience*** and ***conviction*** to obey the rules we have in place. I prefer to take the stance that as long-term investors, we should view sell-offs as opportunities to accumulate, not liquidate. Selling into a fearful market is the equivalent of closing the barn door after the horses have left.

Alberta to Act on Oil

As announced on Sunday December 2nd, the Alberta provincial government has taken steps to reduce the oil glut in western Canada. As mentioned in my previous report, a shortage of take-away capacity, combined with ever increasing production has crushed Canadian pricing differentials. More pipelines are the obvious long-term solution, but this may take years to approve and build. In the meantime, a combination of increased crude-by-rail and production holdbacks will improve the situation. In fact, on the heels of the production cut headlines, I see that Western Canadian Select (WCS) is trading at $32.75 (USD), an increase of $10.82 per barrel or 49% (Dec. 3). Pricing differentials on all Canadian grades have narrowed significantly and this is very positive news.

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Earnings Season

Companies tend to release their quarterly results around the same time. This period is known as ***'earnings season'***.

During earnings season, analysts will focus their attention on a plethora of announcements that are released to the public. Whether a company exceeds consensus (*known as a 'beat'*) or comes up short (*known as a 'miss'*), this new information is quickly reflected in the stock price. When a company *beats*, many analysts will routinely issue an upgrade and the stock price will rise. On the flip side, if a company 'misses', the stock will likely fall. Third quarter results were recently reported and what struck me as *'different this time'* was the number of companies whose *misses* were met with severe punishment. It seems market sentiment has changed.

As an example, Apple (AAPL) released its third quarter earnings after the close on November 1st. While AAPL reported a beat on earnings ($2.91/share vs. an estimated $2.71/share) and exceeded consensus revenues at $62.9 billion (up 20%), the market reaction was negative. APPL stock plummeted in the afterhours market. What seemed like a positive result, was received differently by investors. So, what happened?

CEO Tim Cook disclosed a material change in how earnings would be reported in the future. The *'shock'* was that AAPL would no longer disclose iPhone sales on their quarterly call. The reaction was swift, and the stock was punished. Analyst downgrades flooded in as the announcement fueled suspicion that Apple was trying to camouflage declining iPhone sales. While iPhone sales form a significant share of revenues, Apple had recently disclosed that future growth would center around growing their recurring revenues (i.e. services) rather than unit sales (i.e. iPhones). In my opinion, this makes sense. Unit sales are subject to stiff competition and AAPL recognizes that technological innovation in cell phones has its limitations. Service-based revenues, on the other hand, would be sourced from an existing and loyal user base willing to pay for applications like iTunes, the App Store, iCloud, Apple Pay and Apple Care. In my judgement, the shift to service-based growth is a wise move.

What to do with AAPL?

Price action following AAPL earnings clearly indicated a *'thumbs down'* to Cook's statement regarding iPhone sales. Analysts raced in unison to announce downgrades and lower their price targets. I have long realized this is common behavior amongst analysts - the race to make the claim '*I got it right*', albeit in hind sight!! My question is, *has the Apple story materially changed?*

Apple is a great global company. It has a loyal customer base, is a premier brand, has strong pricing power, technological expertise, a sustainable dividend, growth in recurring revenues, is highly innovative, has massive cash reserves, superior management and a share buyback program to support the stock price! What's not to like about Apple?

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As an investor who seeks both safety and superior returns, it is crucial to remember two important *'rules.'*

Rule 1*: Investment returns are directly related to the price you pay for your investment.* When good companies are overpriced relative to their value, it is crucial to avoid the trap of following the crowd and ultimately *'overpaying'*, simply to *'own it now'.* As the *'FAANGs'* hit their peaks this past summer, it seemed obvious to me that the appetite to own the group had led to inflated valuations. In due course, enthusiasm wanes and ultimately fuels a *'correction'*, as we have recently witnessed in the ''*FAANG's'*, a.k.a. Face Book, Amazon, Apple, Netflix, and Google (Alphabet). While it can be difficult to avoid the *'momentum trap'*, taking a *'pass'* on the action will often yield a better result.

Rule 2: *Exercising patience and discipline are critical.* Waiting for the opportunity to buy an investment on weakness is the key to superior returns. Market fluctuations, corrections, and headline events that create volatility will usually eventually provide such an opportunity. *Is Apple currently mis-priced?* Only time will tell as there are many other market dynamics in play. But one thing is certain. If we agree that the prospects for Apple are essentially unchanged, and that the stock will ultimately return to favour, I'd prefer to be a buyer when it's *'on sale'* rather than when its *'over-priced.'*

The Palos – Mitchell Fund

A quick update. We have been working hard on pushing forward with the Palos-Mitchell Fund. The documentation and regulatory process is in full motion and we are aiming for a mid-January launch. I am very much looking forward to this new approach to managing our clients' assets. Pooled assets in the form of a fund, offer improved efficiencies and allow for enhanced management focus. As each step takes us closer, we will keep you informed with periodic updates.

Holiday Greetings

As my next report will be in January, I would like to take this opportunity to extend our best wishes for a happy and safe holiday season. I consider the opportunity to serve your interests both an honour and a privilege, and I am truly appreciative of your business and your loyalty. Thank You and Happy Holidays!

Best Regards,

Bill

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I am a portfolio manager at Palos Wealth Management based in Montreal, Quebec, Canada. My experience in the investment industry is extensive, having spent more than twenty-nine years analyzing, trading and investing in global financial markets.

At Palos, we are driven by our values. We believe in the principles of honesty, integrity and transparency. We subscribe to a strong work ethic and we have a true passion for investing. The pursuit of excellence is our motivating force. We take our fiduciary duty to heart and we always act in the best interests of our clients.

Should you have any questions about investing, our services, or becoming a client of Palos Wealth Management, please contact me at:

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Disclaimer:

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