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Palos Weekly Commentary

Issue **No. 2** | **JANUARY 10** 2019

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Macro View

By Hubert Marleau

The Weekly Narrative of January 10, 2019

I met Byron a few times, many years ago at the Director's Cup in Aspen with my good dear friend Michael Culver during ski events. We chatted several times and I got to know how insightful and knowledgeable he is about big stuff. His yearly ten surprises are worthy of consideration. The ten surprises for 2019 are below.

Byron R. Wien who is the Vice Chairman of the Private Wealth Solutions group at Blackstone, today issued his list of Ten Surprises for 2019. This is the 34th year Byron has given his views on several economic, financial market, and political surprises for the coming year. Byron defines a "surprise" as an event that the average investor would only assign a one out of three chance of taking place, but which Byron believes is "probable," having a better than 50% likelihood of happening.

Byron started the tradition in 1986 when he was the Chief U.S. Investment Strategist at Morgan Stanley. Byron joined Blackstone in September 2009 as a senior advisor to both the firm and its clients in analyzing economic, political, market and social trends.

Byron's Ten Surprises for 2019 are as follows:
http://advisoranalyst.com/glablog/2019/01/03/byron-wiens-ten-surprises-for-2019.html/

1) The weakening world economy encourages the Federal Reserve to stop raising the federal funds rate during the year. Inflation remains subdued and the 10-year Treasury yield stays below 3.5%. The yield curve remains positive.

2) Partly because of no further rate increases by the Federal Reserve and more attractive valuations as a result of the market decline at the end of 2018, the S&P 500 gains 15% for the year. Rallies and corrections occur but improved earnings enable equities to move higher in a reasonably benign interest rate environment.

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3) Traditional drivers of GDP growth, capital spending and housing, make only modest gains in 2019. The expansion continues, however, because of consumer and government spending. A recession before 2021 seems unlikely.

4) The better tone in the financial markets discourages precious metal investors. Gold drops to $1,000 as the equity markets in the United States and elsewhere improve.

5) The profit outlook for emerging markets brightens and investor interest intensifies because the price earnings ratio is attractive compared to developed markets and historical levels. Continuous expansion of the middle class in the emerging markets provides the consumer buying thrust for earnings growth. China leads and the Shanghai composite rises 25%. The Brazil equity market also comes to life under the country's new conservative leadership.

6) March 29 comes and goes and there is no Brexit deal. Parliament fails to approve one and Theresa May, arguing that a change in leadership won't help the situation, remains in office. A second referendum is held and the U.K. votes to remain.

7) The dollar stabilizes at year-end 2018 levels and stays there throughout the year. Because of concern about the economy, the Federal Reserve stops shrinking its balance sheet, which is interpreted negatively by currency traders. The flow of foreign capital into United States assets slows because of a softer monetary policy and a lack of need for new capital for business expansion.

8) The Mueller investigation results in indictments against members of the Trump Organization closest to the president but the evidence doesn't support any direct action against Trump himself. Nevertheless, an exodus of Trump's most trusted advisors results in a crisis in confidence that the administration has the people and the process to accomplish important goals.

9) Congress, however, with a Democratic majority, gets more done than expected, particularly on trade policy. Progress is made in preserving important parts of the Affordable Care Act and immigration policy. A federal infrastructure program to be implemented in 2020 is announced.

10) Growth stocks continue to provide leadership in the U.S. equity market. Technology and biotech do well as a result of continued strong earnings. Value stocks other than energy-related businesses disappoint because of the slowing economy.

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Every year there are always a few Surprises that do not make the Ten because either I do not think they are as relevant as those on the basic list or I am not comfortable with the idea that they are "probable."

11) Geopolitical tensions increase. Iran continues to destabilize the Middle East and Kim Jong Un fails to live up to his North Korea denuclearization promises. Secretary of State Pompeo and National Security Advisor Bolton make statements indicating the United States may take pre-emptive action in both places, thereby causing one of several sharp market sell-offs. But in spite of hostile rhetoric, the United States does not go to war with anyone as we approach the 2020 election. Trump's tough talk on some issues like trade works, however, and leads to successful diplomatic negotiations on national security.

12) In desperation China engages in ambitious infrastructure programs to bolster its economy. China grows at 6.5% real, but the increased debt causes concern around the world and has a negative impact on the renminbi.

13) China announces, "We want to be the world leaders in free trade." It sends envoys around the globe to negotiate better bilateral trade terms in order to offset the losses from the ongoing U.S. disagreements. Joint ventures in which foreign companies control the majority share are initiated in all sectors, from industrials and autos to raw materials. As China's influence around the world becomes greater, the U.S. further isolates itself.

14) The European Central Bank is forced to restart quantitative easing in response to a defiant Italy, a weakening Germany and Brexit. Thwarting expectations that Brexit would bring the rest of Europe closer together, Italy realizes that it can break all fiscal rules without any fear of punishment from the E.U. As a result, the Italian economy falls into recession, debt spreads surge and the ECB is forced to liquefy the system again.

The Bank of Canada Decided to Keep Interest Rates on Hold. There was zero chance of a rate hike.

I'm not surprised that the Bank of Canada decided to leave its policy rate at 1.75% on Wednesday. The Palos Monetary Policy Index which considers price stability, trade balance viability, employment conditions, and economic growth shows that the Canadian monetary stance should be even keel. The inflation content of the Misery Index, which is the addition of the inflation and unemployment rates, strongly suggests that the Bank of Canada should stay put. The dragging increase in wages (1.5% YoY) less assumed productivity growth for 0.8%, only leaves a 0.7% effect on core inflation. The sputtering slowdown in cyclically interest-sensitive items like housing, business investments and autos,

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assumes that the policy rate is near the neutral level. Plus, the yield curve is essentially flat and so are real rates. Lastly, Governor Poloz did get a break from the stunning recovery in the Canadian dollar from 73.18 to 75.33 us cents.

It would have been just too risky and foolish to go forward with a rate hike when the pace of the real economy is running below potential at less than the annual rate of 2.0% at a time when household debt is dangerously high as a proportion of N-GDP and deep regional vulnerabilities have soared. The lack of political will in Ottawa may be the single greatest threat. Indeed, the macroeconomic backdrop has weakened and there is no upward pressure on the so-called output gap. It may feel as if the sky is falling. The latter may not be justifiable because Statistics Canada is still reporting some good data points. It may be a good time to load up on Canadian equities because investors are evaluating them at deep discounts. For example, the Canadian EPR is 5.77% which is 175 bps better than the U.S. comparable.

What Canada needs are fiscal solutions like pipelines to get our crude oil to markets. I fail to understand why this is not done now. Germain Belzile at the Montreal economic Institute posted recently an interesting story in the Financial Post. Many Albertans might think that Quebecers want nothing to do with Western oil, or any oil for that matter. Nothing could be further than the truth. Let’s start with the obvious:

1) A little more than half of the oil that is consumed in Quebec comes from Canada, and this proportion has been steadily increasing since 2014.

2) Quebecers are ok with that. A large majority of Quebecers, 66%, prefer to get oil from Western Canada, versus 7% who want it from the U.S., 3% from Algeria, and 1% form the Middle East and Nigeria, according to a recent poll conducted by Leger.

3) Quebecers also think oil should be shipped by pipeline and are open to hydrocarbon development in Canada. Indeed, between 1990 and 2017, sales of SUV and light trucks increased by 246% and sale of gasoline jumped by 33%.

Obviously, there is a considerable gap between the typical Quebec political discourse and behaviour and feeling of Quebecers.

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New Technical Perspectives as of January 9, 2019

1) Based on the Dow Theory, the trend for the S&P 500 turned bearish recently with key resistance at 2560 and key support at 2351 - on Thursday morning the S&P 500 was 2581.

2) Based on a proprietary model, the trend for crude oil is neutral with key resistance at $52.61 and key support at $42.68 - on Thursday morning crude traded around $50.81.

3) Based on a proprietary model, the trend for gold turned bullish recently with key resistance at $1,337 and key support at $1,223 - on Thursday morning gold was selling for $1,246.

4) Based on a proprietary model, the trend for ten-year treasury yield recently turned bearish with key resistance at 2.85 % and key support at 2.50% - on Thursday morning the yield was 2.72%.

5) Based on a Palos Currency Model, the trend for the Canadian dollar recently turned bullish with resistance at 76.35 US cents and key support at 73.87 US cents - on Wednesday morning the Loonie was trading for 75.33 US cents, 2.67 US cents below its Purchasing Power parity Rate.

The Recession Risk as of January 9, 2019:

1) Moody's Analytics is predicting that there is a 17% chance of a recession in the next six months.

2) The WSJ December survey predicts that there is a 30% chance of a recession in the next 12 months.

3) A December survey conducted by Reuters mark-up the probability of a U.S. recession in the next 24 months to 40% from 35% in November.

4) The NY Fed yield curve model shows that there is a 21% chance of a recession in the next 12 months----need a 50% probability to get one.

5) The Chicago Fed National Activity Index which combines the real Federal Funds Rate with the yield curve shows a 24% probability of a recession in six months - need a 60% probability to get one.

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The Outlook for the Economic Growth as of January 9, 2019:

1) Moody's Analytics predicts that the U.S. economy grew at the annual rate of 2.7% in Q/4.
2) The Atlanta Fed predicts that the U.S. economy grew at the annual rate of 2.6% in Q/4.
3) The St-Louis Fed predicts that the economy grew at the annual rate 2.8% in Q/4.
4) The WSJ December survey predicts that the economy grew at the annual rate of 2.6% in Q/4.
5) The Cleveland Fed expects that the pace of economic growth to slow around 2.0% in 2019 and 2020.

The Outlook for Inflation:

1) The Cleveland Fed's Inflation NowCasting Model predicts that annual rate of inflation was 1.5% in Q/4. The PCE Deflator is expected to fall to an annual rate 1.0% in Q/1 of 2019 and the CPI to 0.8%.
2) Economists and markets expect a slowdown in inflation resulting mainly from lower oil prices. The U.S. CPI year-over-year increase is expected to fall from 2.0% to 1.0% by July 2019.
3) Goldman Sachs predicts that the yield on ten-year Treasury note will end 2019 at 3.00%. This ties in neatly with a 4% increase in N-GDP—2% for growth plus 2% for inflation.
4) Goldman Sachs also expects that the U.S. dollar will weaken against most currencies as the Fed adopts less aggressive monetary stance—-good for commodities, materials, financial stocks and dividend paying equities.

The Global Demand Outlook for Oil as of December 2018:

1) The EIA predicts that global oil demand should rise by 1.52 million barrels per day in 2019.
2) The IEA predicts that global oil demand should rise by 1.40 million barrels per day in 2019.
3) OPEC predicts that global oil demand should rise by 1.29 million barrels per day in 2019.

The 2019 Outlook for the S&P 500 as of January 9, 2019:

The latest version of the Bloomberg table of 19 banks' year end forecasts, has the median estimate at 3079, a mean of 3052, a high of 3350 and a low of 2750. The forecasts are based on a mean 2019 EPS of $173.05, a medium of $173.00, a high of $179.00 and a low of $168.00.

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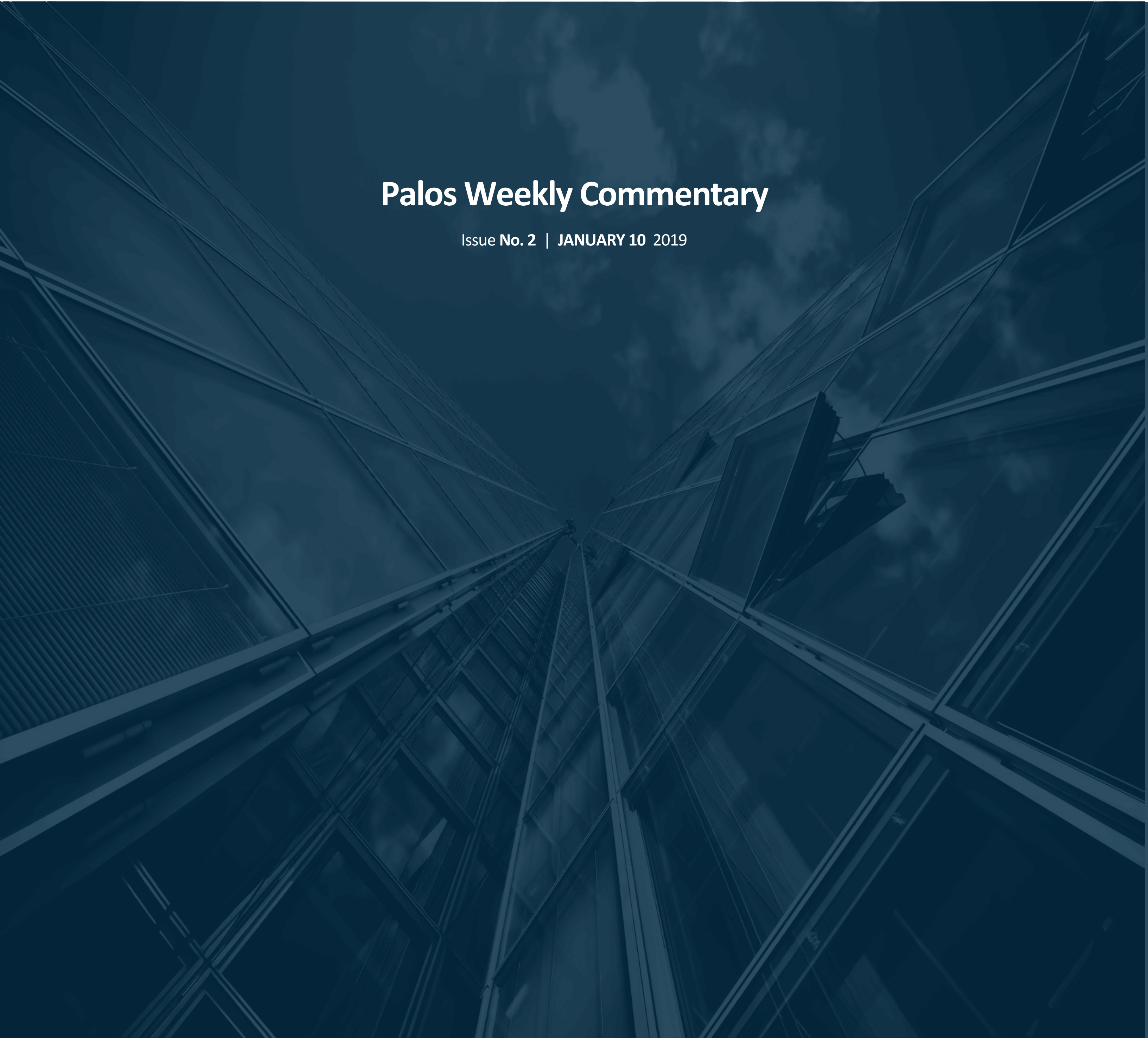

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