To subscribe to our Newsletters www.palos.ca/register

PALOS

Palos Weekly Commentary

Issue No. 14 | APRIL 4 2019

CONTENTS

The Long Game Belongs to the Millenials	1
The Canadian Dollar	2
Good News Is Always Goods: No Matter What	4
Data Points that Matter	5
The Recession Risk	6
Technical Perspectives	7
Disclaimer & Contacts	9

Macro View

By Hubert Marleau

The Weekly Narrative of April 4, 2019

The Long Game Belongs to the Millennials:

Good stock operators are also good statisticians. They know that the stock indices like the S&P 500 are a time series composed of four components - secular, cyclical, seasonal, and irregular (noise). In this regard, active stock operators who take advantage of all four components are the ones who achieve superior market returns over time. After digging through tons of numbers across numerous funds, I found empirical proof that money managers who are aware of time series overperform. A good stock operator is one who can trade dips caused by noise, sense seasonality in stock prices, speculate accurately on business cycle maturity and invest long term in what is about to become secular.

While my weekly missives concentrate mostly on where the trading and speculative opportunities that arise from noise or where we are in the cycle. Today, I will shed some light on what has become a very big and important secular trend. According to the prestigious Pew Research Center, about 73 million Americans were born between 1981 and 1996 - ages 22-37. This oft-defamed cohort defined as Millennials is about to become the single biggest age group in the U.S., surpassing the baby-boomers. Population projections from the U.S. Census Bureau, indicates that they may even be proportionally larger than expected because young immigrants expand their ranks, they are less prone to death and deaths among baby boomers are rising. Let's have a look at what Fundstrat based on UN Data sets have produced. In 2017, the population of Millennials was 89.2 million and it will peak around 95.8 million in 2038. The baby boomers peaked in 1999 at 79.5 million. This demographic maturation will bring significant changes to the U.S. economy. What is particular about this huge demographic change is that the bulk of the replacement of the aging baby boomers will not be met by the Gen-X but by the Millennials. This is a crucial. It will change the dynamics of the economy through the saving-investment equation, productivity and spending patterns.

1) There will be about 74 million baby boomers leaving the saving mode in retirement. They will be replaced by about 66 million Gen-X savers. The key is that the 66 million Gen-X who were borrowers will be replaced by a whopping 95 million Millennials between 2018 and 2038. Millennials will form households and become big borrowers like the boomers did in the 80s and 90's. History is clear on this one. As demographics becomes a major creator of economic growth, big things happen. A rise in household formation requires a

Macro View cont.

By Hubert Marleau

lot of capital and not only in domestic real estate. State and municipalities need to find money to build infrastructures, to create new neighbourhoods, schools, roads, and public transportation. And if it's going to be anything like it was when the boomers were coming of age, interest rates will tend to rise, and main street business activities should flourish.

2) Investors should take note that when the boomers became of age, the US had its best years of productivity gains. If past relationships hold, a marked acceleration in productivity over next two decades can be expected. The millennials, who are now in their early 30s, will soon be entering their most productive years en masse. According to the latest projections from the United Nations, the number of Americans aged 40-49, which currently accounts for 10% of the working population will rise year-by-year to 20% in 2038.

3) Data shows that the millennials are really special and the cohort of Gen-Z which is behind them is even more special. Together, they are creating a generational mindset that is changing the characteristics of spending, redefining the traditional boundaries of investing and disqualifying many rules of finance promoted by business schools. It means that the nature of economies, business cycles, and recessions is evolving. What is happening is that the service and government sectors, which are more stable than the manufacturing sector, have become a much larger part of economies since the 1950s and this evolution will likely accelerate because the apparent behaviour of these two groups aggressively supports service spending and government intervention.

John Authers, a wonderful writer for Bloomberg, is reviewing a book called " Capital Idea" - the must-read classic of Peter Bernstein. In his note to his readers, I came across a paragraph that said, "In 1961, when he was an investment manager, Bernstein's firm started a new strategy based on demographics".

Peter Bernstein wrote: "We called it "investing in the puberty boom." We bought heavy positions in Gillette, Tampax, and Georgia Pacific Lumber for the new homes being built for growing families and accumulated large holdings of IBM." I believe that we understand why he bought the former two. But Bernstein bought IBM because he might have known intuitively that as the baby boomers grew older, they wanted to become very productive and insisted on modernized enterprises. Classic behavioural opportunity.

The Canadian Dollar:

The Purchasing Power Parity Rate for the Canadian dollar is 77.50 us cents. Given that the value of the Loonie closed at 74.75 US cents last Friday, its exchange value is trading at a 3.6% discount. Many firms that trade goods and services on a worldwide basis are wondering if the gap will continue, narrow or widen. It is important because its exchange value creates comparative losses or gains depending whether one is an exporter or an importer of goods or services. Whether that gap will be filled or not will depend on the relative perception of monetary policy between Canada and the U.S., the outlook for Canadian terms of trade, and the comparative attraction of investing in Canada.

Macro View cont.

By Hubert Marleau

Should the officials at the bank of Canada decide to keep an even keel monetary stance, for any given reason, the industrial prices, especially raw materials, would rise fast enough to improve the terms of trade and the investment prospects would remain comparatively attractive, the Loonie would absolutely increase in value against the greenback and probably overtake its PPPR.

The Canadian monetary policy index which takes into account inflation, employment and growth stands at 36 compared to 188 for the U.S.. The higher the index the greater the need for a tighter monetary stance and the lower the index the greater the need for an easier monetary stance. The wide difference between the Canadian and U.S. indices can be explained by the fact that the unemployment rate is lower in the U.S. (3.8%) than in Canada (5.8%) and that growth rate in the U.S. (3.0%) is higher than in Canada (1.6%). Inflation is running at the same pace (1.5%) in both places. Therefore, my calculation puts the neutral rate much lower in Canada (1.45%) than in the U.S. (2.25%) and why the shape of the yield curve is flatter and/or more inverted in Canada. As a matter of fact, Oxford Economics has a higher estimated neutral rate than I at 2.50%. The bottom line is that the policy rate in Canada (1.75%) is too high and the Bank of Canada should immediately cut its target rate by 25 bps to 1.50% whereas the Fed only needs to pause its policy rate at the current 2.38%. Unless short term relative economic conditions are about to change, there will be a market perception that interest rate differentials could widen more in favour of the U.S., putting downward pressure on the Loonie.

Canadian terms of trade which are basically the ratio of export prices to import prices have suffered considerably in the past year declining from 96.0 Q4/2017 to 91.6 in Q4/2018. However, things have improved of late. Raw materials, which happen to be the major component of Canada's export trade, have recovered nicely in the international markets since December. The index for raw material prices increased 3.8% in December, 4.0% in January, and 4.6% in February. Another increase is expected in March, perhaps 3.5%. Improvements in Canadian terms of trade usually works well for the Loonie because Canadian exporters received extra money for their product. It's like getting an injection of capital.

Following the record-setting divestment of Canadian securities and Canadian bonds in December, January brought about the biggest net inflow of capital and money in history. A total of $37.2 billion was injected in Canadian financial system. Foreigners purchased a net amount of $28.4 billion in bonds, stocks and money market paper while Canadians sold net $8.8 billion of foreign securities, effectively bringing money back into Canada. While temporary factors may have caused the surge, it remains that in relative terms the attractiveness of Canadian assets has improved significantly as a result of political dysfunction in the U.S and relative cheapness of Canadian stocks. Canadians, as well as foreign investors, may hold the belief, as I do, that the Loonie will not always be bought at a discount to its PPPR. The IMF released its Currency Composition of Official Foreign Exchange Reserves, known as the Cofer data, and it showed that the claims in Canadian dollars increased in the final quarter of 2018 while those in U.S. dollars were shed. Put simply, the CAN Dollar's market share of central banks currency reserves rose. The interest in Canadian dollar denominated assets may continue. For example, adjusted for foreign exchange value, the TSX is trading for an historical low to the S&P 500 of only 4.25 times - it should be around 5.5x.

Macro View cont.

By Hubert Marleau

My conclusion is that the exchange value of the Canadian dollar could surprise the experts to the upside, especially if the Central bank decides to hold on and not cut rates. There is a lot of negativity embedded in the Canadian dollar which has resulted in large short positions. If speculators were to pare back their bets that the Bank of Canada will independently cut its target rate, the bounce would be fast and furious. As a matter of fact, the Bank of Canada could just as easily decide not to cut because the newest number on GDP growth is 1.6 % year-over-year - it just so happens that the economy's estimated potential is 1.8% - that is close enough for Governor Poloz to hesitate. Plus, he may take solace in the fact that the January surge in economic activity took place while Alberta's mandatory oil production cuts shaved as much as 0.2% off growth. The growth print could have been as high as 0.5%. Investors should take note that the evidence is clear that when a central bank does not decrease its target rate when it ought to, the currency tends to rise in value.

Good News Is Always Goods: No Matter What!

Moody's Analytics Policy Uncertainty Index has been very stable over the last two months, averaging 128.9. That is not to say that the U.S. is out of the woods because the index remains above normal, which has been a constant feature of this economic expansion. Yet, financial conditions as measured by the Chicago Fed are at their easiest since 1994 and the GS Financial Conditions Index has drop like a shoe since January toward easiness.

First quarter GDP growth has boomeranged well past the consensus call for 1.5% growth. The Atlanta Fed GDP NowCasting model is pointing at a growth rate 2.1%. If one believes that the level of interest rates is a driver of economic activity and that valuation of the stock market reflects it, April may turn out to another good month for equities. It's clear that the Fed is not going to raise interest rate for a long time and accordingly good economic numbers will only serve to reduce recession fears.

While it is true that recessions have always been preceded by inverted yield curves, the correlation is not casual because the delays are very long and very variable. As a rule, recessions are caused by asset bubbles, shocks, errors and/or overheating economics. Thus, the shape of the yield curve reflects conditions like inventory imbalances, oil supply shocks, rising inflation, monetary policy error, financial stress or fiscal tightening. History is conclusive on this one. On that score, things are pretty safe at this time.

An Update on Consensus 2019 Forecasts for S&P 500 Earnings Per Share.

Based on analysts' consensus estimates, S&P 500 operating earnings are expected to increase around 4.0% in 2019 and 11.0% in 2020. By quarters, the EPS is expected to decrease 1.9% in Q1, increase 0.8% in Q2, increase 2.4% in Q3 and increase 8.9% in Q4. The earning season starts next week.

Macro View cont.

By Hubert Marleau

Data Points that Matter released in Week ended April 4, 2019

- Canada:
    - The CFIB small business barometer index decreased badly in March to 55.9 from 59.0 in February. It was the worst reading in three years.
    - The Canadian GDP reversed its recent trend in January, exceeded consensus, rising 0.3% in January and making up for the reductions of the previous two months.
    - The first increase in exports (2.9% in January) in five months drove a small decline in the trade balance deficit. The trade deficit totalled $4.25 billion compared to $4.82 billion in January. Canada has deficits with just about every country in the world except the U.S.
    - The industrial product price index roe in February offsetting the January decline, rising 0.3% because of higher energy prices. Year-over-year, the price for industrial products is up 1.2%. Last July, the increase was 6.5% - and guess what Canada had a trade surplus.
    - The average weekly earnings per employee was $1012.00 in January, up 2.0% from a year ago.
    - Markit Economics reported that manufacturing PMI decreased to 50.50 in March from 52.60 in February. The Mfg PMI has been in a declining trend since last June when it peaked at 57.0.
    - The Ivey PMI fell to 50.6 in February from 54.7 in January, the lowest reading since last September.

- The United States:
    - The Kansas City Fed Manufacturing index showed broad improvement in March. The index was 10, significantly above consensus.
    - The Bloomberg Consumer Index is holding well near recent highs at 60.0.
    - Solid economic conditions pushed consumer sentiment higher in the final March report, with sentiment gaining 4.6 points over the previous month and reaching a five-month high of 98.4.
    - New-Home Sales increased modestly in February to 667,000 SAAR. Supply of home in the market was 6.1 months compared to 7.0 in December and 6.5 in January.
    - Nominal personal income growth came in a little light in February, rising 0.2% and less than consensus. Year-over-year the increase in disposable income was 4.2%.
    - Retail sales disappointed in February, falling 0.2%. But retail sales were revised higher in January to 0.7% compared to earlier print of only 0.2%. Year-over-year, total retail sales were up 2.2%. The trend is flat to down. Last July, 7 months ago, total sales were up 6.6% from a year ago.
    - U.S. construction spending advanced 1.0% in February, well ahead of the 0.2% consensus.
    - Business inventories expanded in January by 0.8%, pushing past consensus expectation of 0.5%.
    - U.S. Manufacturing conditions improved in March as the ISM hit 55.3, up from 54.2 in February, exceeding consensus expectation.
    - New orders for durable goods decreased 1.6% in February after 3 consecutive monthly increases.
    - Although the CoreLogic Home Price Index ticked up 0.7%% in February, year-over-year the increase was only 4%, the slowest pace in seven years.

Macro View cont.

By Hubert Marleau

- Purchasing managers in NYC are feeling good about business conditions. The ISM-NYC Report Increased to 66.9 in March compared to 61.1 in February, finally pulling out of a six-month slump.
- Following two months of disappointing sales data, March auto sales came in stronger than expected, rising to 17.5 units.
- Yardeni Research reported that there are more buybacks than new issuance of shares. In Q4/2018, net issuances totalled $180.2 billion.
- After several weeks of robust gains, the mortgage market exploded in the last week of July on the back of a huge increase in refinancing. The MBA Mortgage Application index surged 18.6% to one year high of 503.6.
- The non-manufacturing sector continues to expand, but the breadth of growth narrowed moderately in March to 56.1 compared to 59.7 in February.
- The labour market is showing signs of slowing. The ADP employment survey reported that private-sector payrolls expanded by 129,000 in March compared to 197,000 in February.
- Initial job claims decreased to 202,000 last week, the lowest print December 6, 1969. It shows that the labour market is very tight. The Challenger Report showed that job cuts fell in March to 60,587 last week. Store closings is the biggest cause for job cuts.

- China:
    - China's official manufacturing PMI ticked back into expansion territory after contracting for three consecutive months. The print was 50.5 in March versus 49.2 in the previous month. The non-manufacturing gauge rose as well to 54.8.
    - Citi Economic Data Change Index shows that economic momentum is turning up in Asia.
    - China's service sector activity rebounded in March. The Caixin/Markit China Services PMI rose from 51.1 in February to 54.4 in March.
    - China debt-to-GDP is 300% compared to 340% in the U.S.
    - DCE Iron Ore Futures in China are ripping higher - from $450 a tonne to $675 in three months.

- The Euro-Zone:
    - The Euro-area inflation slowed in March to a headline rate of 1.4% and a core measure of prices which strips out volatile components fell to the lowest pace at 0.8%.
    - German factory orders dropped 8.4% from a year ago, the biggest plunge since 2009.

The Recession Risk as of April 4, 2019:

1) The NY FED's yield curve model shows that the probability of a recession 12-months ahead is 25% - needs to be at 50% to trigger one.
2) Moody's Analytics is presently predicting that there is a 20 % chance of a recession in the next 12 months.

Macro View cont.

By Hubert Marleau

3) The March WSJ survey shows that the chance of having a recession in the next 12 months is 25%, last it was 24%

The Economic Outlook for Q1 2019 as of April 4, 2019

1) The NY Fed is now estimating a 1.3% GDP growth, up from 1.0%
2) The NowCasting Model of the Atlanta Fed increased its view on growth from 1.5% to 2.1 %.
3) The High Frequency Economic Model of Moody's Analytics increased its growth estimate to 2.0% from 1.1%.
4) A Canadian feeder of printed economic data points indicates an annual growth rate of 1.2%.

The Estimated Inflation For Q1 of 2019 as of April 4, 2019:

The Cleveland Fed's Inflation NowCasting Model expects the PCE Deflator to increase at the annual rate 0.7% and the core deflator at 1.5%.

Fourteen Technical Perspectives as of April 4, 2019

1) Based on the Dow Theory, the trend for the S&P 500 is now neutral with key resistance at 2914 and key support at 2743 - on Thursday morning the S&P 500 was 2878
2) Based on a 7-AM proprietary model, the trend for crude oil is neutral with key resistance at $63.50 and key support at $55.99 - on Thursday morning crude traded around $62.51
3) Based on a 7-AM proprietary model, the trend for gold is bullish with key resistance at $1367 and key support at $1242 - on Thursday morning gold was selling for $1296
4) Based on a 7am proprietary model, the trend for ten-year treasury yield is bearish with key resistance at 2.63% and key support at 2.20% - on Thursday morning the yield was 2.52%
5) Based on a Palos proprietary model Currency Model, the trend for the Canadian dollar is higher with resistance at 76.24 us cents and key support at 74.51 us cents - on Thursday morning the Loonie was trading for 75 us cents, The Purchasing Power parity Rate is 77.50 us cents. Rising oil prices should help the Loonie; monetary and economic conditions are improving.
6) The Equity Risk Premium for the S&P 500 is 328 bps, the P/E multiple is 17.3 and the earning yield is 5.80% - 3.89% above inflation expectations. .
7) The Rule of 20, which is the addition of the 12-month forward P/E multiple and 5-year inflation expectation, stands at 19.2 - market neutral

Macro View cont.

By Hubert Marleau

8) The Equity Risk Premium for the TSX 300 is 486 bps, the P/E multiple is 15.2x and the earning yield is 6.56% - 5.40% above inflation expectations. The TSE, foreign exchange adjusted, trades at 4.25 times the S&P 500 compared to 4.31x one month ago and 4.30x three months ago. The 5-year long term average is 5.71x.
9) The U.S. Palos Monetary Policy Index, excluding the current account deficit, is 188. Currently, the index suggests that the economy could take one more rate hike.
10) The Canadian Palos Monetary Policy Index, excluding the current account deficit, is 35. Currently, the index is suggesting that the BoC should cut its target rate to 1.50%. Yet it is unlikely. The reasoning is above in the narrative.
11) The St-Louis Fed Financial Stress Index continues to show steady amelioration. The index touched -1.23 on March 28 compared to -0.62 on December 24. A bullish downtrend that has not relax since last December. The more negative the index, the less stress there is. Financial conditions are good and above average.
12) DXY/Copper ratio is 33.02, and the trend is flat. It's a sign that the economic outlook is stabilizing.
13) ERP/CNN ratio is 54, suggesting that the market is a bit rich. But the trend is positive. A high ratio means that the stock market is very cheap. For example, on December 24, 2018 the ratio was at an all-time high of 2090. One month ago, the ratio was 50.
14) VIX/CNN ratio is 23, also suggesting that the market is a bit rich. But the trend is positive. For example, the ratio was at an all-time high of 1800 on December 24, 2018. A high ratio means that the stock market is very cheap. One month ago, the ratio was 23.

Palos Weekly Commentary

Issue **No. 14** | **APRIL 4** 2019

Disclaimer:

This publication is proprietary to Palos Management Inc. (along with its affiliate Palos Wealth Management Inc., "Palos"). This publication may be copied, downloaded, stored in a retrieval system, further transmitted, reproduced, disseminated, and/or transferred, in any form or by any means, but only as long as it is unaltered and attributed to Palos. This publication and its contents may not be sold or licensed without Palos' written permission. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made or implied regarding accuracy or completeness. The information provided does not constitute investment advice and it should not be relied upon on as such. If you have received this communication in error, please notify us immediately by electronic mail or telephone. This document may contain certain forward-looking statements that are not guarantees of future performance and future results could be materially different. Past performance is not a guarantee of future performance. "S&P" is a registered trademark of Standard and Poor's Financial Services LLC. "TSX" is a registered trademark of TSX Inc. The Bloomberg USD High Yield Corporate Bond Index is a rules-based, marketvalue weighted index engineered to measure publicly issued noninvestment grade USD fixedrate, taxable, corporate bonds. To be included in the index a security must have a minimum par amount of 250MM.

PALOS

1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada

T. +1 (514) 397-0188
F. +1 (514) 397-0199

1 St. Clair Avenue East Suite 504
Toronto, Ontario M4T 2V7

T. +1 (647) 276-0110
F. +1 (647) 276-0110

www.palos.ca