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CONTENTS

There Are Substantive Factors in Play	1
Palos Funds vs. Benchmarks (Total Returns)	6
Disclaimer & Contacts	7

The Palos Perspective

Issue **No. 6** | **February 7, 2025**

A Macro Market View by Hubert Marleau

The Good, the Bad and the Ugly

Last week, I ended my essay with this note: "I trust that the implementation of the proposed tariffs will take enough time for industries to lobby against them, and inevitably lead to some sort of reversal; the North American strategy on trade is irrational. Trump's approach to trade is getting murky. In this connection, it is increasingly important for traders to acknowledge that he uses the stock market as his scorecard. Bad performance here is the only thing that will stop his incoherent strategy on trade. In the last hour of trading on Friday, the S&P 500 dropped 0.5%."

Sure enough, during the early hours on Monday morning, the benchmark was in a freefall, messaging that investors and workers were indeed not in agreement with Trump's actions on tariffs. Why?

First, they know that if there are tariffs, they will have to pay for them in the form of higher prices, fewer choices, and lower productivity. They are an unjustifiable way to transfer wealth from the people to the elites. They are regressive.

Second, there is consensus that there is no rationality behind a breakup of the well-thought-out integration deal of the 3 main North American economies: Mexico can provide an abundance of cheap labour, Canada can contribute immense amounts of minerals and energy, and the U.S. can supply gobs of innovation, research, and technology. As a result of these factors, companies have been able to coordinate these comparative advantages into a complex web of business activity that has benefited all 3 amigos, without relying on outside countries at all. Where else can you find such a beautiful combination?

Third, people had witnessed first-hand the disruption that the pandemic caused, fearing what "shoot-from-the-hip" tactics can do to the supply chain. Larry Summers said: "This is a "stop-or-I'll-shoot-myself-in the-foot" kind of policy. ISM agreed with Larry, calling the Trump tariffs a threat to manufacturing recovery. Even JPM thinks that Trump may be unfriendly to business. Odds are nearly 50% that the courts will block Trump's tariff plans.

Fourth, corporate America is waking up to concerns that a convergence of interest in the face of American bullying friendly nations with tariffs could destroy the unity of the western alliance, turning much of the world against the US - a dream come true for Russia, China and Iran.

Lastly, the baseline economy is healthy. That, at least, is obviously not an issue. Nonetheless the investor public cannot ignore the uncertainties that government policy on tariffs could have on the supply chain, input costs, and retaliation. It's a wild card because what happens with inflation could negatively impact the optimism of both business and the Fed. The smart people at Apollo even think that the monetary authorities may be forced to change their stance.

In the end, despite such autarky tendencies, the U.S. remains a democracy where people have a free vote in the financial market, which hates being damaged by self-inflicted wounds. With a few hours to spare, Trump was quick to settle, as were his opponents, deciding to push the pause button on his planned 25% levy on imports from Mexico for 30 days. Later in the day, Trudeau announced a similar deal, guaranteeing to appoint a "drug czar" to ensure a "Couche-Tard" 24/7 supervision of the border. The panic mode temporarily ceased.

Although Mexico and Canada are not yet out of the woods, the public is pretty optimistic that either the tariffs won't happen or be tampered down. My take is that Trump would like to tear down the USMCA, not to erect higher tariff barriers between Canada, Mexico and the U.S., but to isolate North America as a whole from the rest of the world with tariffs, possibly excluding at a later stages Japan, Australia, and the UK; and perhaps a few countries in South and Central America.

Now the tumult has shifted to China, where the real trade war lies. The additional 10% tariff on Chinese imports have already taken effect. China retaliated quickly, with levies on gas, coal and machinery, retractions on exports of key hard-to-get critical minerals (tungsten, tellurium, ruthenium, molybdenum), and by opening a probe into Google (Incidentally, Google does have much business in China.) The market downplayed the Chinese retaliation because it is not likely to cause much pain, affecting less than 10% of US exports to China. This did not placate the Trump administration, however. On the contrary, he complained about China's trade practices, increasing the odds that the free trade agreement with Beijing could be repealed. Suspending normal trade relations with China, however, would increase levies on Chinese imports substantially.

I do not want to underestimate the tariff problem, but despite it, we have just had a week with a heavy docket of important economic prints on the employment situation and on the earnings report. These were generally good, suggesting that the US will continue to expand profitably; and is why option players are still making bets that the stock market rally will continue for the foreseeable future.

This week's economic data suggests that the labour market has found an equilibrium at full employment. Job openings have declined, along with quits, producing a rough balance between demand for workers and availability. The paycheck company ADP reported that US business had created a solid 183,000 new jobs in January, indicating the labour market still has plenty of mojo. In fact, the employment components of the ISM manufacturing and services index show that hiring is chugging along at a nice pace. Overall, services activity came in weaker than expected; but this is viewed as a silver lining, because it showed that inflationary pressure from the service sector was fading. Indeed, the BLS proved on Friday that the economy is just right at full employment, reporting that it had generated 143,000 jobs in January, keeping the unemployment rate at 4.0% and the labour participation rate steady at 62.6%. This employment report will likely endorse the Atlanta Fed's GDP Model's growth estimate at 2.9% (saar) for Q1/2025. Investors should note that the N.Y. Nowcast model is predicting an even higher growth being 3.1%.

Moreover, the S&P 500 earnings per share are on track to be up 11.5% from a year earlier, on a 4.6% rise in revenues. So far, 80% of the companies that have reported their earnings have beaten the consensus of analysts, exceeding estimates by an average of 6% in an encouragingly broad-based manner. With the exception of energy, all sectors are recording earnings growth. Given that the growth rate of the economy is superior to hours worked, it shows that firms are building business models with less human resources and less money, with technology becoming cheaper and more efficient as it matures and proliferates.

Productivity growth rose 1.6% in Q4, however, less than I expected. I suspect that it is in the process of returning to 2.0%, which has been the trend of the current business cycle, which started in the fourth quarter of 2019 when business technologizing began in earnest. Falling auto inventories dragged down real GDP growth last quarter, stalling auto output weighed on output. Indeed, productivity will probably clock another big gain in Q1/2025.

Meanwhile, I hear from Wall Street that the flurry of statements and executive orders coming out of left field is becoming very challenging for the market. With everyday being a “day of thunder”, Trump is burning through his political capital at an alarming rate, not only with allies but with citizens, risking the long-term effectiveness of his administration. How long Congress and the courts will permit him to challenge the constitutional system, effectively breaking down the idea of checks and balances, is moot; but this must eventually come to a head. Interestingly, consumer sentiment dropped sharply in the early days of February to 67.8% from 71.1%, and was widespread with Republicans, Independents and Democrats alike.

By the end of the week, the S&P 500 closed at 6026, registering a weekly loss of 0.2%.

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$8.71	-1.14%
Palos Equity Income Fund - RRSP	PAL101	$7.41	-1.14%
Palos WP Growth Fund - RRSP	PAL213	$12.82	8.88%
Palos Global Small-Cap Equity Fund[2]	PAL251	$9.81	2.79%
Palos-Mitchell Alpha Fund[3]	PAL300	$11.38	-1.15%
S&P TSX Composite (Total Return with dividends reinvested)			2.45%
S&P 500 (Total Return with dividends reinvested)			2.74%
S&P TSX Venture (Total Return with dividends reinvested)			6.48%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			4.51%
Canadian Government 10-Year			3.01%
Crude Oil Spot			US $72.70
Gold Spot			US $2,871.60
US Gov't10-Year/Moody BAA Corp. Spread			145 bps
USD/CAD Exchange Rate Spot			US $0.6982

[1] *Period ending February 4, 2025. Data extracted from Bloomberg*

[2] *Fund is priced monthly*

[3] *Fund is priced weekly on Tuesdays*

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