To subscribe to our Newsletters, **please send an email to info@palos.ca with subject line "Newsletter"**

PALOS

CONTENTS

The Palos Perspective

Issue **No. 5 | February 1, 2025**

A Macro Market View by Hubert Marleau

There Are Substantive Factors in Play

The stock market regained its footing after Monday's DeepSeek mini-panic because Q4 earnings reports surpassed expectations, the dovish Fed paused, and robust economic growth remained relentless, the BEA having reported on Thursday that GDP had risen at an annual rate of 3.2% in Q4. More importantly, the market realized, after consideration, that DeepSeek could be a big positive for the proliferation of AI, which would boost productivity even more than originally expected.

If anything, the DeepSeek narrative adds fuel to the right tail of Trump's agenda, which was his promise of the largest tax cuts and the largest deregulation campaign in history. This welcome combination of Trump's incentive program with lower internal cost is conclusively bullish. On top of this, the new regime has inherited a very healthy economy that is in a Goldilocks state, the Commerce Department having reported on Thursday that it had risen at an annual rate of 2.3% in the final quarter of 2024. If it had not been for the huge pullback in exports and the frontloading of imports in December plus the destocking of wholesale inventories, the GDP would have risen by as much as 3.5%.

Meanwhile, the Fed's preferred gauge of underlying growth increased by a whopping 4.2%, all this consistent with a technology-led productivity boom. Indicators like the rise in money supply and the drop in job claims, accompanied by improvement in consumer confidence and sentiment are reassuring signs that growth will continue for the foreseeable future. The Atlanta Fed economic tracker even has an estimate of 2.9% for GDP growth in Q1/2025.

The Left Tails of Trump's Agenda:

On Wednesday, however, the Federal Reserve put a damper on this combination by repelling Trump's wish for lower levels of interest rates, thereby asserting its independence. Chairman Powell avoided answering any questions that might have been viewed by the White House as criticism, or passing judgment on whether tariffs and deportations were good or bad. Instead he made it clear that the Fed was in no rush to resume rate cuts, insisting that the current monetary stance was appropriate, but not without some suspicion. Yet the price gauge (PCE index), used by the Fed to set the policy rate, rose 0.3% to mark the biggest increase since last April. Year-over-year, this crucial index rose 2.6%; excluding food and energy, it rose 2.8%. Strangely, the swap market says the odds of a 25 bps reduction in the policy rate before June remain a virtual certainty. In this connection, the immensity of the fiscal deficit is perhaps why, in the final analysis, the gold price surged to a record high of $2850 on Thursday.

A lot of American growth is being financed with an increased amount of debt. It now takes a startling $2 of government debt to generate $1 of GDP growth, which is both unprecedented and higher than all other developed countries. Indeed, things are never that easy when there is an elephant in the room. They can bring hidden consequences, not least two other left tails in Trump's agenda: universal tariffs, which are subject to the laws of unintended consequences, and deportation of illegal immigrants, which is an onerous direct cost for many businesses. It may not be all clear at this point which tails (right or left) will prove to be more important for the future, but as a consequence, neither should be disregarded, for the "Trump trades" may have run their course, thereby pulling bets on "American Exceptionalism." Chinese soft power is rising all over the world.

On trade, meanwhile, the first order of effect is Trump's determination to reduce American demands for imported goods, and by ricochet lessen the demand for foreign currencies.

The second order is the tendency to increase the exchange value of the U.S. dollar and, in turn, decrease the demand for American products and services.

The third order is the incentive for other countries to affix their own set tariffs: retaliate by finding new markets through innovative trade deals; look for shelter in safer frontier markets; and even boycott non-essential goods made in the U.S. (in which context, interestingly, US exports decreased 4.5% in December, widening the trade deficit to a record USD 122.1 billion).

A Macro Market View by Hubert Marleau

The fourth order incentive compelled countries to push R&D programs to disrupt complacency, rendering tariffs ineffective. For example, out of the blue, a startup (DeepSeek) developed a very cheap AI model in a Chinese lab that effectively rivals Open AI, Llama and Anthropic. DeepSeek worked around US export laws and bans that restricted Nvidia chips from reaching China, developing a darn good AI model that operates at a cost 95% less than standard models. Under game theory, cooperation between players is a win-win for all, raising questions about the effectiveness of trade curbs.

When Trump 1.0 introduced tariffs in 2017, the US failed to increase either its trading volume with other nations or create new jobs in American factories. He only increased input costs and tied American industries in knots. World trade moved on without the US, handing it over to other nations instead. Over the past 8 years, its share of international trade to N-GDP has dipped to 25%, while more than 4 out of every 5 countries have registered significant gains. Consequently, the US share of global trade is now under 15%, having opted out of a number of bilateral and regional agreements, and abandoned trade talks on partnerships. To date, the tariff regime has done less damage to China than to compel Mexico, Europe, the Middle and even Canada to look elsewhere to trade. A continuation of this trend could eventually jeopardize the favourable inheritance of a prosperous economy that was unwittingly gifted. Indeed, the application of broader tariffs may trigger trade wars against the U.S. that could not only undermine its relevance as a trading power, but also sap its economic prowess.

To truly shrink its trade deficit, America would have to undergo fundamental economic changes and behaviour that would either increase personal savings and corporate profits and/or decrease business investment and residential construction. It is far from obvious that either one of these would be desirable. A monomaniacal focus on the trade balance has no bearing on the economy's real strength. Perhaps these are the reasons why we haven't heard anything concrete yet.

As to the deportation of illegal immigrants, its macro effect could be devastating on inflation, growth and earnings alike. Massive deportation would directly upend several crucial industries such as service-heavy hospitality and leisure, labour-intensive agriculture, food harvesting, manufacturing and construction, which may explain why Trump has so far held-off on large-scale workplace raids.

Removing 11.7 million unauthorized immigrants is an immense enterprise that could trigger severe shockwaves on the economy. According to the Pew Research Center, they account for 5% of the workforce. According to the Peterson Institute, the economic impact of deporting 7.5 million illegals who are nonetheless workers, would reduce the real GDP by a full 12%. Even ejecting a mere 1.3million immigrants could reduce it by 2.1%. Moreover, deprived of cheap labour, businesses would have to pay higher wages and, in turn, raise prices to protect profits or cut down production, thereby, in turn, restricting supply. While there is a lot of uncertainty here, Main Street is bound to push back in the hope that some of these unauthorized immigrants will be encouraged to deport themselves, thereby discouraging others from entering.

These two risks have not yet perturbed investors, largely because they did not believe that the administration would follow through to their full extent. Up until today, they have been much more focused on what gets actually done than swayed by what Trump threatens. This changed, however, over the weekend. After 80 years, since the regime of Franklin D. Roosevelt in the U.S. and Mackenzie King in Canada, who economically integrated their two nations through constant reduction in tariffs to achieve a free trading zone over time, President Trump decided to collapse the economic order that Americans and Canadians have relied on and become accustomed to.

On Saturday, he confirmed that a 25% tariff would be applied to goods from Canada. His justification for this economic assault is that Canada has enabled illegal drugs to pour into the U.S.; has not taken steps to stop the inflow of illegal immigrants; and has a huge $200 billion trade surplus with America. All of these allegations are false. First, the U.S. Custom and Border Protection (CPB) reported that last year 21,148 pounds of fentanyl at the southwest border were intercepted, versus a tiny 43 pounds at the northern border. Second, Canada has a plan to spend over $1.0 billion on border protection. Third, Canada has a relatively small trading surplus with the US in comparison to its other major trading partners, and on top of that is paid with a service deficit. Canadians just don't know what is left to satisfy Mr. Trump.

A Macro Market View by Hubert Marleau

On January 31 at 17:41 ET, the editorial board of the Wall Street Journal wrote: "President Trump will fire his first tariff salvo on Saturday against those notorious American adversaries…Mexico and Canada. They'll get hit with a 25% border tariff, while China, a real adversary, will endure 10%. This reminds us of the old Bernard Lewis joke that it's risky to be America's enemy but it can be fatal to be its friend." It went on to say that if a North American trade war persists, it will qualify as the dumbest in history. On February 1 at 10:06 ET, the equally conservative American Enterprise Institute had a similar message: "Trump is winging it, saying we have a large trade deficit with Canada when we don't, and that Canadians are responsible for fentanyl coming across the border when they aren't."

I trust that the implementation will take enough time for industries to lobby against them and inevitably lead to some sort of reversal; the strategy 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%.

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$8.82	0.19%
Palos Equity Income Fund - RRSP	PAL101	$7.51	0.21%
Palos WP Growth Fund - RRSP	PAL213	$12.21	3.65%
Palos Global Small-Cap Equity Fund[2]	PAL251	$9.81	0.00%
Palos-Mitchell Alpha Fund [3]	PAL300	$11.33	0.06%
S&P TSX Composite (Total Return with dividends reinvested)			2.97%
S&P 500 (Total Return with dividends reinvested)			3.23%
S&P TSX Venture (Total Return with dividends reinvested)			1.94%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			4.53%
Canadian Government 10-Year			3.20%
Crude Oil Spot			US $73.77
Gold Spot			US $2,767.50
US Gov't10-Year/Moody BAA Corp. Spread			145 bps
USD/CAD Exchange Rate Spot			US $0.6945

[1] *Period ending January 28th, 2025. Data extracted from Bloomberg*
[2] *Fund is priced monthly*
[3] *Fund is priced weekly on Tuesdays*

The Palos Perspective

Issue No. 5 | February 1, 2025

Disclaimer:

L'infolettre Palos Perspective est un aperçu hebdomadaire de la situation macroéconomique disponible uniquement en anglais. Si vous avez des questions sur l'infolettre ou des demandes générales sur Palos, veuillez nous contacter à info@palos.ca