Issue 3

PALOS INVESTMENT FUNDS

January 19, 2017

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

■Portfolio Management & Advisors

Charles Marleau, CIM
President & Senior Portfolio Manager

Hubert Marleau
Economist & Co-Founder

Robert Boisjoli, FCPA, FCA
Chair of the Board

Wakeham Pilot
Director – Wealth Management

Bechara Haddad
Senior Financial Analyst

Joany Pagé
Financial Analyst

Hugo Maurice
Financial Analyst

■Contacts

Lilliane Nguyen, LL.B, LL.M. Fiscalité
Manager, Client Services

Palos Management Inc.
1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada

Disclaimer: No part of this publication or its contents may be copied, downloaded, stored in a retrieval system, further transmitted, or otherwise reproduced, disseminated, transferred, in any form or by any means. This publication is proprietary to Palos Management Inc. 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 as to their accuracy or completeness. The information contained herein is not necessarily complete and its accuracy is not guaranteed by Palos Management Inc. The information provided in this material does not constitute investment advice and it should not be rely on as such. If you have received this communication in error, please notify us immediately by electronic mail or telephone. The overall views expressed in this report are prepared by Palos Management Inc. This document may contain certain forward-looking statements that are not guarantees of future performance and future results that could be materially different from those mentioned. 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, market-value weighted index engineered to measure publicly issued non-investment grade USD fixed-rate, taxable, corporate bonds. To be included in the index a security must have a minimum par amount of 250MM.

Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

Canadian Energy Services Pays Up

On August 1, 2016, Canadian Energy Services & Technology Corp (TSX:CEU) completed its acquisition of Catalyst Oilfield Services (COS). COS is a U.S.-based company that specializes in chemicals for the oil & gas industry. The company is focused in the West Texas area and the Permian Basin. At the time of the announcement, the acquisition seemed expensive. However, CEU is renowned for making expensive acquisitions worthwhile thanks to their vision, execution and integration. The COS acquisition will start to shine shortly. We believe CEU has slowly started its cross-selling strategy to existing COS customers.

COS provides 180 customers with specialty chemicals such as drilling pipe fluid. Most of those customers are in the Permian Basin. This area has over 260 active rigs, which is almost equal to the total number of active rigs in Canada. That customer list is worth its weight in gold. The opportunity for CEU is to vertically integrate its supply chain. Doing so will allow CEU to upsell to clients other CEU products which are generally bigger ticket items.

In conclusion, CEU’s $90 million acquisition for $6.3million of EBITDA seemed expensive at the time of acquisition. However, it seems it will turn out to be a real winner.

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns)*

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.79	0.32%
Palos Equity Income Fund - RRSP	PAL 101	$6.40	0.30%
Palos Merchant Fund L.P. (Sep 30, 2016)	PAL 500	$4.60	-13.07%
Palos IOU High Yield Fund (Dec 31, 2016)	PAL 701	US $7.46	-0.26%
S&P TSX Composite			0.88%
S&P 500			1.20%
S&P TSX Venture			4.04%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			1.04%

Chart 2: Market Data*

	Value
US Government 10-Year	2.47%
Canadian Government 10-Year	1.76%
Crude Oil Spot	US $51.41
Gold Spot	US $1,204.30
US Gov't10-Year/Moody BAA Corp. Spread	221 bps
USD/CAD Exchange Rate Spot	US $0.7509

* Period ending Jan 19, 2017

PALOS
INVESTMENT FUNDS

January 19, 2017

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

■Portfolio Management & Advisors

Charles Marleau, CIM
President & Senior Portfolio Manager

Hubert Marleau
Economist & Co-Founder

Robert Boisjoli, FCPA, FCA
Chair of the Board

Wakeham Pilot
Director – Wealth Management

Bechara Haddad
Senior Financial Analyst

Joany Pagé
Financial Analyst

Hugo Maurice
Financial Analyst

■Contacts

Lilliane Nguyen, LL.B, LL.M. Fiscalité
Manager, Client Services

Palos Management Inc.
1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada
T. +1 (514) 397-0188 F. +1 (514) 397-0199
www.palos.ca

■ What is New on the Macro Level?

By Hubert Marleau

On U.S. Interest Rates: In One Fell Swoop, the Bond Market Recalibrated

Economic forecasting is notoriously difficult. It takes a lot of guts to make predictions. Underlying economic and market variables are not only complex but bi-directional. Moreover, the distinction between secular and cyclical forces can be unclear. Therefore, it is important to record one's forecasts and update them with fresh data on a regular basis. Nevertheless, we have boldly predicted, on numerous occasions over the past year, that the US economy was stuck in a regime of 2% for real growth and 2% for inflation. This pattern has been going on for almost eight years and will likely last as demographics are eroding, global unproductive debt remains substantial and pent-up demand is exhausted. Based on both empirical evidence and theoretical validity, ten-year treasuries should have yielded between 2.50% and 3.00% while the federal funds rate should have traded between 1.25% and 1.50%. Yet, throughout this period under review, the entire yield curve has been much lower than it should have been. The financial crisis, the fear of known unknowns and apprehension over global and domestic uncertainties are the main reasons why the Fed delayed visible normalization of monetary policy. As a matter of fact, the Fed was more dependent on market metrics than economic data during this time. The monetary authorities were very careful not to upset the financial markets. In the process, markets became central bank dependent.

Suddenly, as if out of nowhere, signs have recently appeared indicating that the markets are refocusing on underlying fundamentals and, in turn, relinquishing their veto power over policy. Accordingly, monetary policy may become much more correlated to what is going on in the economy. In this regard, the current bullish standing of the Palos Economic Index and the inflationary composition of the Misery Index strongly suggest that the time has come for the Fed to tighten its view. In terms of employment and inflation, the monetary authorities have essentially gotten the current economic cycle to the desired point. The unemployment rate has been close to 5% for the past year and the Fed's preferred measure of inflationary pressures is just below 2%. It's also important to emphasize that the slow recovery is basically related to a lack of productivity plus an abundance of industrial and resource capacity.

In broad terms, monetary conditions have surreptitiously become less expansionary and less accommodating in the past year. The monetary base and excess reserves are $650 billion and $900 billion respectively, down from the peaks reached in 2014. This is a hidden tightening of the monetary stance. Contrary to the conventional opinion, the Fed has not fallen behind the curve. Should the sharp fall in these monetary aggregates continue, combined with a few more rate hikes, the desired effect of Trump's expansionary policies could be partially trumped. The 35-year bull bond market may be over, but it does not mean that bond yields will go up in an uncontrollable fashion. We believe bond yields will be range-bound between 2.50% and 3.00%. The recent price performance in both copper and gold markets supports the aforementioned idea.

If you have any questions about the weekly commentary, the securities that we follow, or investment ideas, please contact us at info@palos.ca