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# Palos Weekly Commentary

## ■ Palos Income Fund

By Charles Marleau

### AltaGas Swallows a Big Fish

AltaGas Ltd (ALA:TSX) is buying WGL Holdings Inc (WGL: NYSE) for \$6 billion. This deal will allow ALA to expand its energy infrastructure portfolio in North America. This will give ALA a foothold in the Marcellus/ Utica basin. In addition, it will add to its clean power portfolio. Once combined, the company will be a leader in the North American energy market.

Here are some high-level details on the acquisition. The acquisition can be split into three segments: Midstream, Utility and Power.

1) **Midstream Business:**

- Brings about growth and exposure in the Marcellus/Utica basin.
- Creates pipeline exposure with long-term contracts.
- Leverages the growth of the Transco Pipeline system.

2) **Utility Business:**

- WGL utility business is well-diversified in high growth states.
- Good potential for asset optimization.
- Both companies have a strong track record of growing and acquiring utilities.
- The combined rate base will be \$4.5 billion and will grow to \$8 billion by 2021.
- Clear visibility of growth.

3) **Power Business:**

- WGL brings stable cash flows under long-term contracts.
- Solar distribution in 19 states.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	\$9.88	1.25%
Palos Equity Income Fund - RRSP	PAL 101	\$6.45	1.21%
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			2.30%
S&P 500			2.68%
S&P TSX Venture			5.11%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			1.23%

**Chart 2: Market Data\***

	Value
US Government 10-Year	2.51%
Canadian Government 10-Year	1.82%
Crude Oil Spot	US \$53.75
Gold Spot	US \$1,188.10
US Gov't10-Year/Moody BAA Corp. Spread	223 bps
USD/CAD Exchange Rate Spot	US \$0.7624

\* Period ending Jan 26, 2017

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- Combined, they will have over \$1.5 billion in projects.
- Generation Capacity of 1,919MW
- The power assets have various organic growth opportunities.

In conclusion, we see the combination of ALA and WGL as a very strong fit. Combined, they will have scale, diversification in their business segments and, most importantly, the business and culture of both companies seem very compatible. Financially, the merger will bring significant growth opportunities and is accretive to EPS. Management believes that in the first year of the merger, EPS accretion will be 7% to 9% and 8% to 10% on average through 2021. Management is confident that this merger will support an 8% to 10% dividend growth through 2021. In addition, the acquisition will also bring the payout ratios lower. We are very much in favor of this acquisition as it locks in growth for the next 5 years.

## ■ What is New on the Macro Level?

By *Hubert Marleau*

### Current Economic Conditions

It's impossible to justly assess market conditions without a good idea and clear understanding of what is currently going on in the economy. Therefore, we record and review daily, financial, monetary and economic data and transform it into model and rule form. This exercise helps us to rationally follow trends in inflation, employment, business activity, credit and, in turn, determine the short-term economic outlook and the medium-term risk for a recession.

On January 26, 2017, high frequency models were tracking a 2.4% annual rate of growth for the quarter ended December 31, 2016 and most measures of inflation were running above 2.0%. The good news is that the economy is in pretty good shape. The Citigroup U.S. Economic Surprise Index, which shows how economic data measures up to expectations, rose to 44.6 last Friday, the highest level since September 2014. The index has been rising steadily in recent months, thus supporting the assumption that the recession risk is very low and that financial stress is essentially non-apparent. Accordingly, there seems to be sufficient pricing power, coming from rising inflation and growth, to produce an increase of 6.5% in S&P 500 earnings in the last quarter of 2016 and possibly to generate a 13.5% increase in the first quarter of 2017.

Unfortunately, our foresight is not perfect as there are too many “what ifs” on the fiscal and monetary policy fronts. The gap between reality and expectation could widen. As we start 2017, we are cautiously positive. Most measures of collective market sentiment are frozen near neutrality. The CNN Fear and Greed Index is almost perfectly neutral. The market is range-bound between 2225 and 2290 and volatility has evaporated.

We think that we will get more of the same 2.0% growth and 2.0 % inflation for the foreseeable future. We are confident, but we must remain alert. There is the possibility that growth could significantly exceed 2.0% if the promised corporate tax cuts are implemented. There is also the risk that inflation could run past the Fed's desired rate of 2.0% if we are indeed at full employment and if border adjustments, in the form of tariffs or quotas, are applied. Reflation has room to run. That is why we opine that U.S. treasury yields are heading higher, to a range between 2.50% and 3.00%. Given these scenarios, we are long cyclicals and small caps, but not at the expense of allocating new capital to value stocks as interest rates rise. Currently, we are a net seller of the auto sectors thus producing more cash than usual.

*If you have any questions about the weekly commentary, the securities that we follow, or investment ideas, please contact us at [info@palos.ca](mailto:info@palos.ca)*