

February 2, 2017

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## Palos Weekly Commentary

### ■ Palos Income Fund

By Charles Marleau

#### Tweet = #Gold

We have never been a big gold bug. However, in the era of Trump tweets, some gold exposure seems strategic. The Palos Income fund has increased its exposure to gold equity to 5.2% percent, which is a historic high. The challenge with most gold companies is that they don't pay a dividend. It's difficult for them to allocate a percentage of their cash flow to dividend. Most companies need to re-invest in their projects, seek new opportunities or acquire competitors. Therefore, we prefer to invest in gold-focused royalty and streaming companies like Franco-Nevada Corporation (TSX:FNV) and Osisko Gold Royalties Ltd (TSX:OR). This model allows for the diversification of mines and cash flow to be distributed to shareholders. FNV is the leading gold royalty and streaming company with the largest and most diversified portfolio of cash-flow producing assets. Here is its revenue breakdown:

Precious Metal	% Revenue
Gold	66
Silver	21
Platinum & Palladium	8
Oil & Gas	5
Geographic Area	% Revenue
Latin America	49
Canada	19
US	15
Rest of the world	17

FNV has a diversified portfolio of 340 assets across the world and the royalty and stream agreements are done with strong counterparties such as Barrick, Newmont, AngloGold, Glencore, Cenovus and Lundin. FNV is also debt-free and has over US\$1.4 Billion of available capital for new deals. The company has a 9-year track record of increasing its dividend. FNV provides diversification, cash flow, a strong balance sheet, and exposure to gold. It's exactly what the fund is looking for. By investing in FNV, we eliminate the risk of being overexposed to one project, operational hiccups and Government uncertainty.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	\$9.79	0.30%
Palos Equity Income Fund - RRSP	PAL 101	\$6.40	0.28%
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			0.94%
S&P 500			2.01%
S&P TSX Venture			7.07%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			1.41%

**Chart 2: Market Data\***

	Value
US Government 10-Year	2.47%
Canadian Government 10-Year	1.77%
Crude Oil Spot	US \$53.64
Gold Spot	US \$1,214.90
US Gov't10-Year/Moody BAA Corp. Spread	224 bps
USD/CAD Exchange Rate Spot	US \$0.7677

\* Period ending Feb 2, 2017

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## ■ What is New on the Macro Level?

By Hubert Marleau

### The Moderate Pace of Economic Activity is Avoiding Accidents

Last Friday, the BEA reported that the level of economic activity in the U.S. increased 3.5% year over year. Employment growth represented 2.5% of the overall increase while productivity and inflation accounted for 0.4 % and 1.6% respectively. While the pace was somewhat less than many market strategists expected, the internal numbers support high frequency economic models that are tracking a 2.4% growth for the first quarter of 2017 and 1.7% for inflation. It should also be noted that the probability of a recession over the next six months is only 9%, and that there are no apparent stresses in either the financial markets or the banking industry.

We have observed several significant changes in the composition of the GDP numbers. Firstly, the steep fall in the monetary base has not negatively reduced the pace of the money supply nor the velocity of money. It appears the banks are making better use of their monetary resources as they are extending bank credit to the private sector. Secondly, the downward trend in productivity may have ceased. It registered its first uptick in nine months. It would appear that business investments, particularly in technology, are stimulating labor efficiency. Business investment is the main source of productivity. The numbers show that it takes a proportionally lesser amount of business investments to produce a 1% increase in real growth. This observation gives some hope that productivity may be on the rise. Thirdly, the rate of inflation is clearly trending upward. The GDP Inflation Deflator confirms that inflation is brewing on several fronts. The deflator is 1.6 % higher than it was one year ago, and has been trending upward for three consecutive quarters. Fourthly, new GDP data gives additional reasons for the Fed to tighten its monetary stance. Interest sensitive expenditure like durable goods, residential construction, business formation and inventory changes accounted for more than 25% of GDP; a threshold that usually brings about higher interest rates.

We've entered the new data in our models to adjust our forecast for interest rates and stock prices. If we were to keep oil prices at \$55 a barrel, long term interest rates could possibly rise to 3.00%, suggesting that monetary authorities

should hike rates at least twice in 2017 and that the S&P 500 could top 2400 before the end of the year. That is, if pro-growth policies like deregulation, tax cuts and infrastructure investments are introduced as promised. We trust that the anticipated reduction in corporate taxes will not be compromised with border adjustments which could cause devaluations and trade wars.

The Fed decided to leave interest rates where they are and offered no clue as to when the next hike will occur. The monetary authorities are waiting for a timeline and details on Trump's pro-growth policies.

*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)*