Issue 11

PALOS
INVESTMENT FUNDS

March 16, 2017

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

Ignoring the Good

The Canadian Natural Gas industry is being side swept by short-term investors. Despite the industry receiving very good news over the past week, the market is being blinded by lower energy prices. The following are a few positives being ignored by the market:

- Alliance Pipeline announced a 0.5 billion cubic feet per day (bcf/d) expansion, which is a 30% boost to the pipeline's capacity of 1.65 bcf/d to 2.15 bcf/d. The Alliance Pipeline transports natural gas to Illinois, in the heart of the US Midwest. The producers that ship via Alliance get a premium price for their gas. The increased capacity is a positive for the industry as a whole.
- TransCanada confirmed that its Mainline into Dawn, Ontario has received 1.5 bcf/d of commitments from key producers. The commitment is for 10 years under a reduced toll of $0.77/gigajoules(GJ) versus today's $1.65/GJ. The reduced toll should give some Canadian natural gas producers a fighting chance against the Nexus/Rover pipeline and its US Marcellus gas producers trying to enter the Ontario market.
- TransCanada is also expanding its NGTL system. When completed, this will debottleneck the Gas Transmission Northwest System (GTN) and allow an additional 0.5 bcf/d of gas to flow to California.
- Thanks to the Alberta power consumption, TransAlta has made a commitment to convert its coal power plants into natural gas. We assume this will generate a demand of 0.5 bcf/d.
- The US Gulf Coast's exporting facilities ship 1bcf/d and that number is expected to grow to 9 bcf/d by 2020.

It may seem like gloom and doom for Canadian Natural Gas producers. However, there are large changes at work that will support the industry for the next decade. And that is not including the Pacific North West LNG project.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.83	0.78%
Palos Equity Income Fund - RRSP	PAL 101	$6.44	0.90%
Palos Merchant Fund L.P. (Dec 31, 2016)	PAL 500	$4.33	-16.73%
Palos IOU High Yield Fund (Feb 28, 2017)	PAL 701	US $7.37	-1.23%
Palos WP Growth Fund - RRSP (Mar 14, 2017)	PAL200	US $9.60	-3.99%
S&P TSX Composite			2.33%
S&P 500			6.86%
S&P TSX Venture			6.40%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			2.10%

Chart 2: Market Data*

	Value
US Government 10-Year	2.54%
Canadian Government 10-Year	1.80%
Crude Oil Spot	US $48.77
Gold Spot	US $1,226.10
US Gov't10-Year/Moody BAA Corp. Spread	222 bps
USD/CAD Exchange Rate Spot	US $0.7508

* Period ending Mar 16, 2017

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We are confident that the Natural Gas industry will become larger and more important to the future of world energy consumption. However, North American gas prices are expected to be volatile in the next few years as the industry gears up its infrastructure. Natural Gas, via LNG, has the chance of becoming North America's largest commodity export in the coming years. We are invested in two natural gas producers which we believe can perform in any natural gas pricing environment and take advantage of the future. Our funds hold Seven Generations Energy (TSX:VII) and Arc Resources Ltd (TSX:ARX), which, in our opinion, are among the lowest cost producers with massive inventories.

■ What is New on the Macro Level?

By Hubert Marleau

The Canadian Dollar

Our calculations show that the Purchasing Power Parity Rate of the Canadian dollar is around 80 US cents. This view is also supported by the World Price Index published by the World Economics and the Big Mac Index published by the Economist. Despite printing three monthly trade balance surpluses in a row and reporting 12 monthly net inflow of foreign capital since January 2016, the exchange value of the Canadian dollar is undervalued by as much as 5 US cents. It should be noted that exchange rates vary with extraordinary rapidity and they frequently diverge with economic reality. The reasons for the difference between the real value and market value of the Loonie will last as long as the spot price for crude stays below its marginal cost of production, which we establish to be between $55 and $60 a barrel, and as long as the dovish monetary stance of the Bank of Canada remains in place. Investors should take note that the Palos Monetary Index currently stands at 122, the inflationary content of the Misery Index is near 25%, interest sensitive expenditures are near 30% of GDP and High Frequency Economic models are suggesting that economic growth in Canada (2.2%) is running faster than in the US (1.0%). As a matter of fact, rates on two-year bonds are at their highest level (0.85%) in 24 months, pushing the chances of a rate hike to over 50% in 2017. Historically, the Canadian monetary authorities have followed, with a lag, the U.S. monetary cycle because the two economies have a high degree of synchronization.

The Global Oil Complex

Our research about cost shows that, in order to meet global demand over the coming decade, the price of crude oil must reach a sustainable $60 a barrel, which is pretty close to the $55 marginal cost of producing a barrel. A recent survey by Raymond James showed that U.S. liquids production should hit 20 MM bpd by 2030 and that 25 MM bpd is a real possibility. If one was to assume that, on average, 1200 rigs would be in operation with a 5% annual gains in productivity, $55-$60 oil would be needed. Investors should count on $60 oil as the long-term base case. What is interesting is that demand fundamentals do not shift much when consumption steadily rises around 1.5% per year. Unfortunately, the oil prices and outputs are cyclically volatile, financially sensitive to noise, subject to secret deals and geopolitical turmoil. Accordingly, the oil market is often turbulent because the supply environment can suddenly change. The oil market was boring since OPEC decided to cut production in November 2016 to support prices. Initially, oil prices rose and then plateaued, hovering between $52 to $56, as if the market was in a cooperative Nash equilibrium, which is defined as an optimum solution where oil suppliers work together to agree on a price that increases total revenue. At first, everything was hunky-dory. The OPEC arrangement was not spoiled by any apparent cheating. While OPEC and Russia were limiting production, the roughnecks in the North American oil patch stepped-up their activity, putting up more rigs and increasing oil output by almost 500 million barrels a day. A number beyond what is required to meet domestic demand. Thus, a build-up in inventories occurred in the hope of stealing market share. They were able to do so because the cost of lifting shale oil dropped below $50 a barrel. Traders got nervous and rapidly covered their long positions, pushing oil prices down to a low of $47.50. Of course, the Saudis showed their discontent, promising that they will not subsidize foreign suppliers at the expense of losing more market share than they already have. This effort may force oil producers to put aside their differences, tacitly cooperate and rid themselves, for now, of the herd mentality of selling. Currently, the price of crude is 12% less than where it ought to be.

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U.S. Monetary Policy and Interest Rates

There are several factors that influence the price of money and the cost of capital. But, in the fullness of time, the level of interest rates is determined by a mixture of the past and expected pace of economic growth and the rate of inflation. Currently, we are in a moderate two-plus-two economy. That is, 2% inflation and 2% growth. In this regard, we should expect the yield on ten-year treasuries to reach 3.00% by year end and for the federal funds rate to settle at 1.25%-1.50%. On Wednesday, the FOMC raised the target rate, as expected, to 0.75%-1.00%, with a clear message that the Fed is very satisfied with the current pace of inflation and the employment situation. Investors should bank on two more rate hikes in 2017. However, the Fed does not want to initiate a rapid rate hike spree as it is not confident enough that real growth could go beyond 2% to meet Trump's expectation of 3%-4%.

Corporate Profit

Given that the U.S. economy is expected to increase around 4% in nominal terms, that producer prices are rising faster than wage rates and that business sales are strong, better profit margins could bring about a 10 % increase in earnings in 2017. Estimates for earning per share for the S&P 500 should total $130.00 in 2017.

What is Fair Value of the S&P 500?

If our base case expectation for interest rates, oil prices and profit growth is correct, we calculate the present fair value of the S&P 500 to be 2300. That is 3% less than the current measure of 2380. If for any reason the pace of real GDP was to reach 4.0%, the fair value would be much higher at 2410. In other words, the stock market is pricing in Trump with an accommodating Fed. It should be noted that Moody's Analytics is very bullish as it places fair value at 2490.

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