PALOS INVESTMENT FUNDS

March 23, 2017

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

Flooding The Canyon

On March 22, 2017 Canyon Services Group Inc. (TSX:FRC) announced that it was being acquired by Trican Well Service Ltd (TSX:TCW). The combined operations of FRC and TCW will make it the leader in pressure pumping in Canada. The combined entity will have over 675k of hydraulic horsepower (HHP) which is approximately 35% of the Canadian fracing capacity.

FRC shareholders, such as our funds, will be receiving 1.7 shares of TCW which is a 32% premium over the closing price on March 21, 2017. We decided to keep our position in FRC and will patiently wait for the transaction to settle. We believe the whole fracing sector was well overdue for some consolidation. The combination of FRC and TCW should restore some pricing power in the fracing market. In addition, it will become the largest Canadian fracer with a market cap of above $1.2 billion.

This should allow larger mutual funds to re-invest in the sector. The fracing sector has been orphaned in the past few years as the downturn in the energy sector put pressure on fracers' market cap. This consolidation will bring girth and a new institutional audience to the space. The acquisition of FRC is also accretive to TCW, which will continue to have a strong balance sheet. In conclusion, the combined company will be stronger and will have a better chance of creating shareholder value.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.74	-0.16%
Palos Equity Income Fund - RRSP	PAL 101	$6.38	0.06%
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 21, 2017)	PAL200	US $9.58	-4.17%
S&P TSX Composite			1.50%
S&P 500			5.29%
S&P TSX Venture			5.14%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			2.05%

Chart 2: Market Data*

	Value
US Government 10-Year	2.42%
Canadian Government 10-Year	1.69%
Crude Oil Spot	US $47.71
Gold Spot	US $1,244.90
US Gov't10-Year/Moody BAA Corp. Spread	223 bps
USD/CAD Exchange Rate Spot	US $0.7488

* Period ending Mar 23, 2017

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■ What is New on the Macro Level?

By Hubert Marleau

U.S. Economic Outlook: Recession Fears or Hope for Growth

Economists are good at explaining the past and making up theories to justify why certain things occurred, but can be quite inaccurate when forecasting future events. In part, it is because recessions are only statically known in hindsight. By definition, a recession occurs after two consecutive quarters of negative growth, by the time this materializes, it is too late. In my opinion, recessions can be forecasted before the fact if we understand what causes them and pay close attention to various signals. As such, we monitor high frequency economic trackers, movements in the yield curve, real interest rates and weekly leading economic indicators. At this time, there are no current signs of an ongoing recession or that one is upon us. Based on concrete changes, Moody calculates that the risk of having a recession within the next six months is very low at only 8% while the WSJ gives a low 14% recession probability.

It should be noted that beliefs and narratives passed on by thousands of people also play a key role in determining big shifts in the economy. Recessions tend to begin when significant, contagious and popular stories cause a reduction in individuals' motivation to spend money and may even change cultural values like morality and religiosity. History shows that very powerful catalytic events are needed to affect mass psychology like spiking oil prices, rapid-fire increases in inflation, the subprime mortgage fiasco, a freezing up of the financial system, a currency collapse or other awful events.

Fortunately for seasoned investors, surveys of consumer sentiment and business confidence are not widely used by the general population. The former, therefore gets an edge when using this data, usually obtained by paying for expensive subscriptions, spending hours on social media and specialty websites. The latter commonly receives information from other channels like word of mouth. Moody's Analytics Survey of Business Confidence shows that US business sentiment is upbeat and stood at 41% and is consistent with an economy that is expanding above its growth potential. What is most encouraging is the high percentage of respondents who say that present conditions are improving and expected to remain firm. A report from Deloitte, looking at business and economic trends in the privately held and mid-market segment, showed that 83% of the executives surveyed are confident that the U.S. economy can generate real growth more than 3.5% over the next 12 months. Yet, the US Economic Policy Uncertainty Index is high at 97.1. It is related to the timing, composition and size of Trump's planned fiscal stimulus. Investors' hope, that a GOP controlled Washington would push through a series of reforms and stimulus programs that would boost productivity, is weakening.

People are concerned about exceptionally low economic growth. Lack of normal growth has caused huge financial inequality, major political anxiety and divergent social objectives. The rate of growth for the last 15 years has been just 1.9%, which is significantly lower than any cycle-growth registered since 1934. We call this "secular stagnation" and commoners blame this nasty condition on the rising and high debt level, disruptive technology and unfair globalization. The transformation of these broad beliefs is now built into reports about financial misdoings, potential collapses of venerable institutions, the dishonesty of media and a cheating elite. According to the World Happiness Report, Americans are becoming less happy. The US ranked 19th among 34 OECD countries in 2016. In comparison, Canada ranked 6th. As Jeffrey D. Sachs wrote, "The predominant discourse in the U.S. is aimed at raising economic growth with the goal of restoring the American dream and the happiness that is supposed to accompany it."

Because of these compelling forces, the equation of savings to investment has fallen out of whack. There is a theoretical explanation for this phenomenon. Put simply, when a widely-spread feeling of anxiety, apprehension and insecurity is in the air, households and businesses spend less and save a large portion of their earned income and profit. Such savings can drain away demand and lower economic activity, unless the savings are reinvested through lending and/or new opportunities. As a rule, central banks manage this process by trying to equate planned savings with desired investments by manipulating the cost of money. Sometimes desired investments are so low and desired savings so high, that central banks are blocked, even defeated, and we find ourselves with zero-bound interest rates. In other words, the gap between desired savings and investments can be too large to reconcile. This is often the result of a scarcity of attractive investments, the fear of another financial cycle drag and the belief that full employment can be achieved if demand is connected with rising asset prices and easy credit.

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Herein enters populism with a commitment to take a different approach. This is difficult for someone like me who is absorbed in neoclassical economic theory and a monetarist with Austrian economic inclinations. Extricating myself from my usual established rhetoric, I'm prepared to accept the manifested optimism of the will. The optimism of populism thinks that it can overcome this chronic economic weakness by bringing in bold new measures like tax cuts to increase investment returns, regulatory reforms to speed up start-ups and investments and infrastructure programs. Populism is hopeful that courageous fiscal policies will be able to correct this saving-investment imbalance, and bring growth back to 4%. Currently, we are stuck at a 2.0% growth rate and the Fed thinks that it will not change. I beg to differ. The question is whether the renewal idea is possible. Going forward, we think that 4% is very challenging. However, if the labour force participation continues to register small upticks and if our forecast of long term productivity gains of 2.5% holds, a long-term rate of economic growth of 3.0% to 3.5% is more probable than possible. Of course, this forecast is based on an avoidance of protectionism and global trade wars. Additionally, U.S. economic policy uncertainty is rising. Trump is spending too much time on trying to repeal Obama Care and not enough on his planned economic ideas. The goodies that the Americans have been waiting for appear to be less likely to occur or could be pushed back. Take note that there are many signals pointing to a revival of the "animal spirit".

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