PALOS
INVESTMENT FUNDS

April 20, 2017

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

Equitable Bank

A chicken keeper out of the US has been tweeting false news about Equitable Group Inc. (TSX:EQB). The chicken keeper made allegations that EQB's Guaranteed Investment Certificates (GICs) were removed from the BMO and Scotiabank investor platforms. We made a few calls on Bay Street and quickly concluded that the above statement was false. EQB's GICs are still being offered at BMO and Scotiabank. Despite the allegations being false, the market was spooked and all mortgage lenders quickly traded down.

We see the mortgage lending space as a difficult one to invest in, especially with all the noise on the Canadian housing market. In addition, there is speculation that new measures to cool the Toronto housing market may be introduced by the Ontario Finance Minister. Investors fear that these potential measures will affect mortgage loan origination for the mortgage lenders. We see these new mortgage rules as a potentially net positive for EQB. Our thinking is that prime borrowers, who are usually customers of the bank, will be pushed into the alternative market. EQB is well-positioned to take advantage of this.

In addition to the above, one of EQB's competitors, Home Capital Group (TSX:HCG), is under some serious scrutiny by the Ontario Securities Commission (OSC). HCG and three of its current or former executives are being accused of making false and misleading statements to the public and the OSC. HCG is down 70% from its high on November 4th, 2014. On the other hand, EQB is down 13.3% for the same period. We however believe that the negative sentiment on HCG has added to the selling pressure on EQB. It's important to remember that EQB is not HCG and that the management teams and culture could not be more different. EQB has been investing in technology and has a much more conservative management team.

With all the commotion, we view the price action on EQB as an opportunity for the following reasons:

- OSFI published the monthly statutory balance sheets for the Canadian lenders exiting February 2017. EQB had another solid month of growth in its loan book and earnings. Management continues to achieve strong performance.
- On April 18, 2017, Stephen Smith announced that he purchased, through

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.78	2.24%
Palos Equity Income Fund - RRSP	PAL 101	$6.43	2.46%
Palos Merchant Fund L.P. (Dec 31, 2016)	PAL 500	$4.33	-16.73%
Palos IOU High Yield Fund (Mar 31, 2017)	PAL 701	US $7.17	-1.40%
Palos WP Growth Fund - RRSP	PAL200	$9.96	-0.45%
S&P TSX Composite			3.00%
S&P 500			5.87%
S&P TSX Venture			8.32%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			2.90%

Chart 2: Market Data*

	Value
US Government 10-Year	2.23%
Canadian Government 10-Year	1.48%
Crude Oil Spot	US $50.27
Gold Spot	US $1,281.90
US Gov't10-Year/Moody BAA Corp. Spread	229 bps
USD/CAD Exchange Rate Spot	US $0.7424

* Period ending Apr 20, 2017

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First National Securities, 88,400 common shares at $63. His ownership now stands at 18.99%.

- EQB is undervalued compared to its peers as it trades at 6.3x EPS or 1.13x P/B.
- EQB has grown to approximately $22.3 billion in assets under management.
- Most recently, EQB launched a digital banking division, EQ Bank, and introduced the EQ Bank Savings Plus Account.
- The bank is an industry leader in uninsured single-family mortgages.
- EQB has high quality credit and a proven management team.

We are slowly investing in EQB as we expect headlines to overshadow its fundamentals for the time being. In our experience, fundamentals will always prevail in the long-term.

■ What is New on the Macro Level?

By Hubert Marleau

The Global Oil Complex

The marginal cost of finding, developing and lifting a barrel of oil is $60. The present price is $51. The spot price is lower than the equilibrium price because there is an over-abundance of oil. There are three main reasons. Firstly, the North American shales have brought about an unexpectedly large production increase. Secondly, the consumption growth has considerably decelerated. Thirdly, competition for market share has intensified. As a result, an enormous oil glut has emerged and it has been difficult to get rid of. Nevertheless, crude oil inventories, while declining less than expected, are now firmly below, in terms of days of supply, the peak level in both the US and the rest of the world. This explains why hedge funds are still net long despite yesterday's steep decline.

Last November, OPEC, in an agreement with Russia, decided to reduce production by 1.2 million barrels a day for six months. OPEC hoped that it would elevate oil prices above $50 per barrel, keeping oil prices near $55 a barrel and perhaps bringing the price back to fair value. Unfortunately, the spot price never quite made it to the desired price level. Technological advances and cheap capital have made it possible for shale oil producers in North America to partially offset the November cuts, while world demand for oil was held in check. Surprisingly, the big oil producers amicably complied with the November cuts and, in turn, permitted oil prices to rise but not enough to satisfy their wishes. It is a foregone conclusion that OPEC and Russia will likely extend the November cuts another six months on May 25, 2017. Should the production cuts be maintained for another six months, another chunk of the oil glut will be eaten up. The effort could take oil prices closer to its just value. Incidentally, there is consensus among the major oil producers that $60 a barrel is the objective. Saudi Arabia's Energy Minister made it clear that his government will do what is necessary to balance the market. Moreover, oil producers may get some help from further weakness in the U.S. dollar. There is normally a direct mathematical price relationship between dollar and oil price movements. Lately, treasury yields have fallen fast, making interest differentials less favorable for capital inflows. Currently, economic activity is growing faster abroad than it is in the U.S.. The IMF just reported that the global economy is on an uptick, forecasting a 3.5 % growth factor for 2017 and 3.8 % for 2018. Thus, it is rational to think that conditions and events will, sooner or later, rebalance the supply\demand equation. Once the glut is gone, oil prices should trade up toward the marginal cost of production. This also explains why speculators are net long.

A conflict is brewing that could lead to a confrontation between the various producers and may bring about a marketing war. The U.S. is no longer an area of export growth for foreign oil producers. Net imports of oil have more than halved in the last few years. Accordingly. global oil flows are dramatically changing and fierce competition is distorting historical patterns. It follows that the current production cuts are not likely to be permanent as oil producers are searching for new markets to sell their oil. For example, Russia is making headway at the expense of Saudi Arabia in Asia, while the Saudis are trying to increase their market share in Europe at the expense of Russia. Big expenditure plans in the oil space have been dropped, not only because oil prices are relatively low, but also because another price war may be looming.

Surreptitiously, renewable sources of energy, such as solar and wind, are growing fast and replacing fossil fuels. Eventually, the day will come when one year's growth in demand for energy will be completely met by solar and wind power. If global energy demand was to grow at 1.5% per year and renewable energy at 20%, a tipping point could be reached in 2024.

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Lastly, our calculation of the equilibrium price of oil is based on the notion that the swing force of the U.S. shale oil is here to stay. We've assumed that in the future, North America will work with an average of about 1200 rigs with productivity gains of 5% a year. During the past five years, productivity has been much higher. It's conceivable that gains in productivity could exceed 5% a year. In which case, the marginal cost of oil could be dragged down to $50 in a few years. Put simply, downside risk exists even if oil may be worth 60$ a barrel.

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