PALOS INVESTMENT FUNDS

April 27, 2017

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

Trading Subscription Receipts

The Canadian market has a few large pending deals that have been financed by subscription receipts. This type of financing structure ensures the acquirer that it will have the cash it needs to complete the acquisition; the common stock is however only issued when the acquisition formally closes. When the deal closes, the subscription receipt gets converted into common stock. On the other hand, if the deal does not close, the subscription receipts will mature and investors will get their money back. This type of financing structure is very attractive for investors because it allows them to invest in a post-acquisition entity while eliminating the risk that the acquisition will not be completed.

We have been active in three specific subscription receipts:

- Tricon Capital Group-Sub-Rct (TCN/R) issued at $9.90.
- SNC-Lavalin Group-Sub-Rct (SNC/R) issued at $51.45.
- Altagas-Sub-Rct (ALA/R) issued at $31.00.

Our favorite arbitrage opportunity is ALA/R and ALA. The sub-rec is trading at $29.83, a discount to its issue price and the common stock. The arbitrage trade involves shorting ALA, which trades at $30.60, and buying ALA/R at $29.80 for a $0.80 spread. At the closing of the deal, the fund will gain $0.80 minus the cost of borrow, which is minimal. In addition, the sub-rec pays a dividend which is equivalent to the dividend of the common stock. This strategy has a minimal amount of risk and volatility thereby enhancing return with minimal risk.

We are being patient and waiting for volatility to widen the spread. Please note that not all sub-recs are the same; especially when it comes to dividends. Some pay out at the same time as the common shares while others accumulate the dividend and only distribute it at the closing of the deal.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.62	0.62%
Palos Equity Income Fund - RRSP	PAL 101	$6.35	1.11%
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	$9.76	-2.37%
S&P TSX Composite			2.34%
S&P 500			7.36%
S&P TSX Venture			5.19%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			3.22%

Chart 2: Market Data*

	Value
US Government 10-Year	2.29%
Canadian Government 10-Year	1.58%
Crude Oil Spot	US $48.97
Gold Spot	US $1,265.30
US Gov't10-Year/Moody BAA Corp. Spread	229 bps
USD/CAD Exchange Rate Spot	US $0.7335

* Period ending Apr 27, 2017

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■ What is New on the Macro Level?

By Hubert Marleau

The Canadian Dollar

We have not seen any statistical or data reports on Canada that would change our view that the purchasing power rate of the Canadian dollar should be different from the 78 U.S. cents that we suggested six weeks ago. Yet, the Loonie continues to be under downward pressure. On Thursday morning, it was trading near 73.50 U.S. cents. Net speculative positions are on the short side representing as much as 30% of all open interest. There are several reasons why the Canadian dollar is trading far away from its fair value. To list a few:

- The Bank of Canada appears to favour a weaker currency. Policy makers are pointing to the fact that inflation measures have been drifting down in recent months along with a poor wage growth. They are not confident that the recovery is on a firm footing and are convinced that material excess capacity exists. Moreover, household debt is high and financing a housing bubble. The central bank is in no rush to hike rates which signals that the stance is neutral. Economic logic dictates that governor Poloz should indeed wait. The Palos monetary policy index is 100 and the inflationary content of the misery index is below the 25% tipping point.
- Terms of trade are unfavorable as commodity prices are relatively cheap. Canada is a very large exporter of natural resources. As a rule, Canadian terms of trade are a function of commodity prices. Accordingly, the performance of the CRB index is a leading indicator of where the terms of trade and trade balances are heading. Canada registered trade surpluses during the first two months of 2017. During that period, the CRB index was 225, a recent peak, and 25 % higher than a year ago. In the past month, the index has decreased significantly and is up only 1.0% year over year. Recent gains in Canada's terms of trade have evaporated and repeated trade deficits can be expected.
- Canada has a current account deficit that accounts for almost 3.0% of N-GDP. It is not normal nor usual for countries with current account deficits to be creditor nations or net lenders of capital. This is because foreign capital is needed to finance current account deficits, otherwise the country risks recession. Over the two past years, Canadian investors' affinity for U.S. assets was especially pronounced. As a result, U.S. dollar deposits have considerably increased.
- Canadian companies, like Cenovus Energy, are buying out large Canadian assets held by foreign entities while others, like SNC-Lavalin, are buying foreign assets.
- U.S. retaliatory actions against Canada over trade disputes could become common, leading to immediate negative economic consequences. President Trump has said that he will sign an order setting into motion a U.S. withdrawal from NAFTA. This morning, the White House announced that it has instead favored renegotiations that would benefit all three nations. The Loonie And the Peso reacted positively to the announcement.

Put simply, all or many of these factors need to be permanently fixed for the Canadian dollar to revert to its fair value.

Resume of the WSJ's "Daily Shots" for the week ended April 26, 2017

- With about 30% of the S&P 500 companies having reported, after-tax earnings are up slightly more than 10% from a year ago.
- President Trump plans to unveil a proposal to cut corporate taxes on U.S. companies' foreign earnings and slash the top tax rate on "pass through" businesses to 15% from the current 35%, without border tax adjustments. Moreover, he is proposing a reduction in the number of individual income tax brackets to three: 10%, 25% and 35%.
- Oil prices in the U.S. are below $50 a barrel because of large oil supplies and stable to declining demand. This benefits the global economy as lower energy prices function as tax cuts. Oil prices may stay below the marginal cost of oil production because it is in the interest of the Saudis to bankrupt as many marginal producers as possible, even if this includes their own investors.
- President Trump plans to impose a 20% import tariff on Canadian softwood lumber. Canada is not the right target for an ugly trade dispute at this juncture. The U.S. trade deficit is very small and the U.S. enjoys a large service trade surplus with Canada. The Pew Research Center recently reported that more than 50% of Americans support free trade agreements and see them as being a good thing.
- The Canadian dollar took a severe hit after the news of the lumber tariffs was released.
- According to Moody's Investors Service, Vancouver and Toronto housing prices

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increased 150% and 110% respectively since 2005. While Montreal and Ottawa housing prices only increased 50%.

- According to Moritz Schularick, there is little evidence that populists are bad for markets. On the contrary, financial history shows that over two and five years, stock prices go up, bond prices go down and exchange rates go up. That is for the 27 cases of populism over the last 100 years. He defines populists as charismatic, confrontational politicians who claim to speak for "the people" and not the elites that often pursue protectionist and nationalist policies.
- Jan Hatzius, the chief economist at Goldman Sachs and one of the sharpest minds on Wall Street, argued on Bloomberg TV that the risk of recession is quite low for 2017 and 2018. He claims that there is a "relative lack of big financial imbalances" which are usually observed before a decline in economic output. The Goldman Sachs Financial Conditions index is near a recent record low at 99.6.
- The Conference Board reported that U.S. consumer sentiment is still near a multi-high high.
- Who is right? The Atlanta Fed forecasts a 0.5% annual rate of increase for the first quarter of 2017 and the NY Fed is betting for a 2.5% increase.
- Latest opinion polls suggest that Mr. Macron will win the French Presidential election against Ms. Le Pen with between 62% and 64% of the votes.
- Evidence suggesting that global inflation may have already peaked is starting to accumulate. Both the NYT and WSJ have articles pointing to this possibility.
- International investors should be aware that the IMF has demonstrated, at the latest annual spring meetings in Washington, that the increasing integration of global markets and economies, in addition to new technologies, is accelerating the transmission of financial shocks from one region to another. This is making it difficult for emerging countries to manage their banking system.

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