Issue 20

Palos Weekly Commentary

PALOS
INVESTMENT FUNDS

May 18, 2017

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■ Annonces / Announcement

[English to follow]

Veuillez noter que Charles Marleau est absent du bureau cette semaine et ne publiera pas son commentaire hebdomadaire. Il sera de retour la semaine prochaine.

Please note that Charles Marleau is out of the office this week and will not publish his weekly commentary. He will be back to write his commentary next week.

■ What is New on the Macro Level?

By Hubert Marleau

Will Stock Prices Hold?

The old age and the elevated valuation of stock market averages are causing concerns that the bull trend may be nearing its end and that a bad turn is imminent. While we recognize that skittishness can bring about market corrections when valuation metrics are ahead of themselves, secular bear trends are only firmly in place when recession risks are very high. Investors often misjudge what is going on. When the situation is too abstract, people tend to go along with the general consensus as it is socially acceptable and expected of them. These natural herd tendencies are psychological pro-cyclical behaviors that can often go too far, which increases the probability of being wrong. Knowing when to bet with or against the trend is a difficult task that is often neglected. Guessing is much easier. Seasoned investors, on the other hand, tend to drop "greed and fear" in favor of "rules and self-control". To have reliable rules, a large amount of historical data is needed.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.65	0.90%
Palos Equity Income Fund - RRSP	PAL 101	$6.36	1.25%
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	$9.80	-1.61%
S&P TSX Composite			0.93%
S&P 500			6.51%
S&P TSX Venture			5.25%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			3.40%

Chart 2: Market Data*

	Value
US Government 10-Year	2.23%
Canadian Government 10-Year	1.45%
Crude Oil Spot	US $49.34
Gold Spot	US $1,246.80
US Gov't10-Year/Moody BAA Corp. Spread	226 bps
USD/CAD Exchange Rate Spot	US $0.7351

* Period ending May 18, 2017

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In this way, algorithms tend to be more logical and rational when creating rules, making it possible for investors to secure a hill top view. Acting on historical similarities is better than acting on recent occurrences.

As a starting point, a very simple algorithm that takes into consideration three equally weighted factors, can easily become a lifesaver. The three factors are: the running shape of the yield curve, the price action of copper and the performance of the real cost of money. History clearly demonstrates that the price of risky assets is influenced by the aforementioned forces; particularly when they act in concert. Think of it as a recipe. Stock market returns love widening yield curves that are combined with rising copper prices and declining real money rates. They however hates narrowing yield curves when combined with declining copper prices and rising real rates. It should be noted that we are dealing with the law of large numbers. The effect of these factors on stock market returns is a reliable guide that one can observe going back as far as 1870. While this simple model can capture stock market movements quite well, we often need to go to the second level of thinking and proof because the model can take us outside the box and create either malignant losses or lavish returns. In other words, at extremes, the model has behavioral aspects that can disregard rationality. To improve the reliability of the above recipe and avoid big macro losses and/or capture big macro opportunities, we closely watch a large variety of factors. These include: High Frequency Economic Models, Recession Risk Indices, Leading Economic Indicators, The Taylor Rule, Monetary Policy Index, Indices of Financial and Banking Stress, Productivity-Employment-Inflation Trends, Corporate Profitability, Debt Ratios, Fiscal Strategic Assumptions and Industry-Tipping Points. These moving variables have been proven to be a reliable second line of support. One would be tempted to ask why we use so many hangers. Put simply, if the sample is too small, it becomes more likely that the true odds may be miscalculated. It also reduces the chances of exaggerating the influence of any one factor. In real life, judging the probable occurrence of a recession is essentially unique and its probability can't be evaluated by a simple tally of instances. To avoid making decisions without complete certainty, looking at a large number of factors allows investors to act incrementally and prudently on what the initial algorithm is showing. As a matter of fact, there is a lot that can be learned about the direction of the economy from watching the aforementioned factors.

Our work on this area suggests that a market correction is very possible given the elevated valuation metrics. Yet, it could turn into a very opportune time to increase one's exposure to risky assets as the chances of falling into a recession are relatively low. On the contrary, and if the Trump-Comey dispute does not become an impeachable offence, the probability that the current bull market will live on is pretty good and more so if the productivity factor, as we expect, was to surprise the market with vigor. The betting market is pricing in a 25% probability that Trump could lose the presidency. It's small, but rising. Last February the probability was 15%.

It is important to keep in mind that history clearly demonstrates that economics trump politics when it comes to stock prices. In any case, periodic losses should be treated with equanimity. In order to earn above-average investment returns, one has to be willing to lose some money on occasion. Stocks do not crash each time they fall. Interestingly, stocks are down about 50% of the time. Yet, they generated yearly positive returns 80% of the time and are up over 11% per year since 1950.

P.S. Nothing is ever perfect and there is no one right way to invest. Accordingly, we welcome comments for continual improvements will compound over time and lead to desirable results. Do not hesitate to contact me at: hmarleau@palos.ca.

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