Issue 21

PALOS
INVESTMENT FUNDS

May 25, 2017

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■Portfolio Management & Advisors

Charles Marleau, CIM
President & Senior Portfolio Manager

Hubert Marleau
Economist & Co-Founder

Robert Boisjoli, FCPA, FCA
Chair of the Board

Wakeham Pilot
Director – Wealth Management

Bechara Haddad
Portfolio Manager

Joany Pagé
Financial Analyst

■Contacts

Palos Management Inc.
1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada
T. +1 (514) 397-0188 F. +1 (514) 397-0199
www.palos.ca

Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

Yes!!! BlackBerry!

Blackberry Ltd. (TSX:BB) is no longer a hardware company. It's smartphone business is now being licensed and trademarked to companies that want to fabricate smartphones. Blackberry is now fully focusing on software services which can be broken down into 4 segments:

- **Enterprise Mobility Management:** BB is a leader in providing security systems to all devices that link together. The opportunity for BB in this segment is remarkable because the market is exploding. On average, 10 million new elements are added every day. In 2016, 3.9 billion smartphones and 6.4 billion connected elements were in use. Ericsson mobility believes this will grow to 6.1 billion smartphones and 20.8 billion connected 'things' by 2020. We believe that demand for mobility security will be explosive in the coming years especially with what we've seen happening around the world. Hacking is on the rise and companies, governments, as well as the military will need to be protected.
- **QNX:** BB is also a leader in operating systems for cars. The QNX system is used by 40 automobile makers and that number is growing. As cars get smarter, more features are added and demand for smarter cars grows, we anticipate the average return per unit to rise in the coming years.
- **RADAR:** This is BB's newest technology and is still in its infant stage. Radar is a trailer tracking system built to increase trailer fleet efficiency and other features such as gaging temperatures, weight, etc. The opportunity is significant as there are 3 trailers per truck and the industry is far from being efficient.
- **Security Solution:** BB refers to this system as the McAfee of the industry since it is a virus scanner for cars. As self-

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.77	2.15%
Palos Equity Income Fund - RRSP	PAL 101	$6.42	2.31%
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	$9.93	-1.61%
S&P TSX Composite			1.84%
S&P 500			8.76%
S&P TSX Venture			5.12%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			3.39%

Chart 2: Market Data*

	Value
US Government 10-Year	2.25%
Canadian Government 10-Year	1.46%
Crude Oil Spot	US $48.64
Gold Spot	US $1,255.70
US Gov't10-Year/Moody BAA Corp. Spread	226 bps
USD/CAD Exchange Rate Spot	US $0.7415

* Period ending May 25, 2017

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driving vehicles become more popular, they will also become more and more prone to hackers. Look at this video on YouTube to see what we mean: https://www.youtube.com/watch?v=MK0SrxBC1xs. BB is well positioned to protect vehicles from such disasters and potential hacking of the new software available in them

As we know, information sharing is vital to all segments of our economy and government. The complexities are greater, larger, and are at greater risk of being hacked today with all the new developments. The connection of all things is on the rise and security will be of the utmost importance. An interesting takeaway recently is that cyber-attack costs have reached $400 billion annually and 50% of CEO's have stated that they do not feel adequately prepared for any kind of cyber-attacks.

■ What is New on the Macro Level?

By Hubert Marleau

The Complications Surrounding the Canadian Dollar

It is crucial for investors to have an idea under what environment the Canadian dollar trades. It's exchange price especially against the greenback can have significant implications for corporate profits, households spending, business capital formation, financial investments, monetary policy, strategic business decisions and speculation.

Unfortunately, the foreign exchange market is difficult to comprehend for it is almost too large and too complex even for those who have tons of knowledge about its workings. Nobody knows everything with certainty for the diversity of market participants fabricates different objectives. To compensate for this incompetence, market participants like to operate their practice under a relatively assumed fix environment that allows the forex market under such circumstances to be efficient within bounded rationality. For example, traders trade order flows, speculators bets on trends, commercial businesses and financial managers either take naked position or hedge their exposure and governments tries to smooth fluctuations. Random ups and downs are the consequences of changing financial and commercial data; but, when theses occur too quickly and too much imbalances emerge creating a new environment. In this respect, irrational movements often erupt. Investors love to forecast and plan ahead and at times under wrong environments. This is what happened to the Canadian dollar.

The Canada has been subject a series of drastic, sudden and negative shocks in the last few years that brought about serious financial changes to its economic environment. It took time for the Loonie to digest the brand-new environment. It followed the cobweb theorem of cyclical expectation meaning that the market adjustments were gradual and in stages. But, steady and lasting. Since the start of 2013, hedge funds have built large net short exposure to the Canadian dollar. In the last four and half years, the Canadian dollar declined from a near peak of 100 us cents in December 2012 to a recent low of 70 us cents in January 2016. It has since recovered a bit to 74.50 us cents. If the environment for the Loonie was to change from what has been going on until now to what may go on in the future, a reformulation of expectation would take the price of the Loonie to where it belongs.

Our take is that the exchange price of the Loonie is undervalued against the U.S. dollar. The Sauder School of Business at the University of British University calculates that purchasing power parity of the CDN$ is more than 10% undervalued against the greenback. Furthermore, the Economist's Big Mac Index support that the above view. If one was to run the Canadian producer prices along those in the U.S. for a ten-year period it would show that the value of the CDN is at least $0.785. Please note that that everyone can know the price of everything but not the value of anything. In this connection, the market is pricing in everything that seems negative that creates fear and loathing. We should not be surprised about this anomaly. In order for the Canadian dollar to trade at its just value, the financial and economic environment would need to change and be more normal. It would then demonstrate some measurable stability for the market would be less behavioral and more rational. For example,

1. The Bank of Canada would need to emulate more closely the Fed's monetary stance. This has not yet happen. The Palos Monetary Indices clearly show that Canada ought to follow a much easier monetary policy than the U.S. For example, the bond yields are much lower in canada than they are in the U.S. and the money supply is running faster in

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Canada. There are no empirical signals that show that the situation is about to change. On the one hand, the Fed is concerned that the labor market could blow past full employment and fear that an unsuspected and sudden acceleration in inflationary pressure could erupt. In this connection, the Fed would prefer the financial markets to be less supportive for growth. A modest decline in equity markets or rise in interest rates would be seen more as therapeutic than a game changer. On the other hand, the Bank of Canada is fearful. The Canadian economy is no way near full employment and inflationary pressures are absent. Moreover, Governor Poloz, a former executive at the Export Development Bank, is said to be part of a sly and shrewd scheme to boost exports. It may be an aggressive assumption but the plot is viewed as a way to compensate for the destruction of the terms of trade that the fall in oil prices has caused.

2. Oil prices collapsed at the end of 2014 because supply and demand got out of whack. That year global supply grew 2.5 times faster than demand. We are still stuck with this situation because the shale revolution in the U.S. and tar sands efficiencies in Canada are generating enough new oil to partially offset the OPEC production cuts. Daniel Yergin, a leading expert on oil matter, argues that a great struggle is unfolding in the global oil complex. On one side are forces pushing to rebalance supply and demand; on the other, are those pulling to calibrate the business so that it may operate at lower cost. The tension is keeping price between $60 a barrel and $40. This recalibration will push up supply more than had been anticipated over the next few years. It should be noted that the cost saving that results from innovation, efficiency and focus will eventually stop doing its thing. There will be a time when headcount reduction, idle rigs and spending cutbacks will stop. That will help the restoration of Canada's terms of trade. Another way to look at is through the oil futures market. Currently, we have a market contango that allows shale drillers to hedge future production at higher prices for delivery later. Should OPEC succeed in its effort to flip the market to a state of backwardation, front month oil contracts would trade at a premium to oil futures making it disadvantageous to store oil for traders would realize a lower price in the future. Flipping that curve would drain inventories and, perhaps, keep the North American production at bay. The exercise would increase the spot price.
3. President Trump's administration officially notified Congress last week that the US intends to renegotiate the North American Free Trade Agreement (NAFTA) with Canada and Mexico in 90 days. This is a big deal for Canada for about one third of the Canadian economy is in one way or another tightly tied to the U.S. and disrupting the well-established supply chains could cause harm. Trump has been all over the map on NAFTA. He said three things. He talk about scrapping it, tweaking it, and massively change it. One thing is sure, he wants to change the dispute resolution mechanism. The U.S. Trade Representative Robert Lighthizer wrote a letter to Congress stating that "our aim is that NAFTA be modernized to include new provisions to address intellectual property rights, regulatory practices, state-owned enterprises, services, custom procedures, sanitary and phytosanitary measures, labor environment and small and medium enterprises". While I recognize that there is no hint of protectionism and its more about expanding exports, Trump did mention that he was unhappy with the energy aspect of the deal. It seems that the U.S. is in a hurry. And that is worrisome. The midterm election are coming up, a coalition of labor and environmental groups including the Sierra Club are pressing for major environmental changes and Trump's base of disaffected working-class voters are aggrieved by globalization. Trump is not popular and the republicans do want to lose their comfortable majority. There is mounting pressure on him to follow through on this pledge. Chrystia Freeland describes the upcoming renegotiation as an opportunity. Right. When there are are major trade changes in the air, foreign exchange markets remain uncertain until the new realities are known by the market.
4. Pipelines are necessary for Canada's prosperity. Unfortunately, most of Canada's energy endowment is landlocked. Accordingly, many are

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taking advantages of their geography. Aboriginal rights, provincial greed and excessive environmental demand are making it difficult for the fossil industry to bring their potential production to markets. It's a shame, in some way, for without energy the wheels of industry won't turn. Hopefully, there will be a day of reckoning about the stupidity of preventing our energy abundance to be put to good use in Canada and abroad. What may save the day, is the U.S. State Department. It's behind the approval of the Keystone XL pipeline. The document argues that Canadian energy is extremely important. Therefore, it could be used as a trump card in the NAFTA renegotiation. Canada role as the largest and fastest growing source of crude imports cannot be dismissed. Plus, Canadian oil is a stable and secure source because of its geologic certainty of future supply. It would be a mistake for the US to neglect this potential for Canada may decide to redirect this reliable supply to Asia. In this connection, the Liberal government will have to increase the value that's it puts on Canadian oil and stop activists to hold Canada hostage and guarantee all Canadian trade and commerce access to their coasts.

5. Household debt, every other way one looks at it, is far too high. It is portrayed by all market participants as being too much. According to the Bank of Canada and the Ministry of Finance, the quality of mortgages is deteriorating and many are risky. The average Canadians have borrowed beyond their means to purchase homes. Canada appears to be overbuilt outstripping demographic demand resulting in overpriced real estate. Goldman Sachs puts the risk of a housing bust in Canada at 30%. The model uses three standard metrics to make their evaluation. They are: the ratio of house prices to rent, the ratio of house prices to personal disposable income and house prices adjusted to inflation. Despite the well capitalize position of Canadian banks, Moody's Investors Service judged that they merited a downgrade. A more stable real estate environment is needed to stop the perception of possible distress before it becomes a reality.

What is interesting is that foreign investors have not lost their appetite for Canada. They still find Canada attractive. Even though interest rates in Canada are far less favorable than in many developed countries, foreigners are still investing a lot of money in Canadian securities. In the three months ended March 2017, $70 billion poured in. Maybe, they think that the pessimistic environment that surrounds the Loonie may eventually change and they can pick up a good bargain. It is not hard to imagine a return of the Loonie to its purchasing power parity rate with the greenback. Off course, the environment would have to change. Palos has been negative on the Canadian Dollar for a long time. It's now basically neutral. We are on the lookout for possible improvements in the environment for we are aware that our currency is undervalued.

A. On Wednesday, Governor Poloz changed its tune. The Bank of Canada recognized that recent economic data has been encouraging and that the economy is adjusting to the decline oil price. The swap market may be pricing only a 25% chance of a rate hike in 2017, Poloz was nevertheless clear that the balance is leaning more to the side of hiking rates. The Bank projects that real output expanded at the annualized pace of 3.8% in the March quarter. That is excellent on its own; but coming off a 3.2% increase in the second half of 2016, it's fabulous. While the language used by Poloz will likely resemble that of Yellen, the Bank of Canada is not likely to imitate the Fed's monetary policy actions. The pace of economic activity is about to moderate, the economy has more excess capacity and less inflation than in the U.S.

B. On the question of pipelines, the time to act is approaching. Canada's constitution recognizes that interprovincial and international trade fall under federal jurisdiction. It is up to Ottawa. Our understanding is that the National Energy Board supports pipelines to the East Coast as well as to the West Coast.

C. The housing situation in Canada presents a real risk. Household debt is about 175% of personal disposable income. This makes the Canadian financial system vulnerable to change in asset prices and interest rates. So far, a series of macro-prudential measures have been introduced to restrain the housing boom. It may not be enough. Therefore, more regulations can be expected with complimentary help from the central bank.

D. Another major question mark is oil prices. It appears that Canada's terms of trade have stabilize with the recent recovery in oil prices. But an improvement is a must. In this

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regard, the contango market for oil would need to change to a backwardation one. This can only happen if Opec can be successful in its quest to correct the global oil complex to its liking. And, that will be hard to do for as long as shale oil production keeps on rising.

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