Issue 22

PALOS
INVESTMENT FUNDS

June 1, 2017

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

[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

Is the U.S. Economy Heading Towards a Recession?

A serious debate over incoming economic data and the Fed’s future interest rate decisions is brewing. On one side, some economists are warning that with unemployment below current estimates of full employment, additional rate hikes are needed to prevent a costly overshoot of inflation above the Fed’s two percent target. On the other side, economists are arguing that with inflation running below target, additional rate hikes could slow inflation further and restrain the economic expansion. Only time will tell which scenario will become reality. Nevertheless, a dispassionate discussion is warranted. The causal logic is that when the labor market gets tight and broad inflation causes cost pressures to exceed selling prices, the cost of money tends to increase faster than the return on capital, thus leading to profit reduction. The outcome brings about a

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.82	2.73%
Palos Equity Income Fund - RRSP	PAL 101	$6.45	2.69%
Palos Merchant Fund L.P. (Mar 31, 2017)	PAL 500	$4.13	-15.22%
Palos IOU High Yield Fund (Mar 31, 2017)	PAL 701	US $7.17	-1.40%
Palos WP Growth Fund - RRSP	PAL200	$10.03	0.02%
S&P TSX Composite			2.32%
S&P 500			9.50%
S&P TSX Venture			5.21%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			3.50%

Chart 2: Market Data*

	Value
US Government 10-Year	2.21%
Canadian Government 10-Year	1.43%
Crude Oil Spot	US $48.06
Gold Spot	US $1,264.70
US Gov't10-Year/Moody BAA Corp. Spread	224 bps
USD/CAD Exchange Rate Spot	US $0.7395

* Period ending Jun 1, 2017

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retrenchment in cyclical spending, reversing the expansion. Consequently, cyclical reversals in economic activity are about the yield curve, inflation and employment. As a matter of fact, these variables tend to revert to their mean. Free market forces make mean reversion true. There is an abundance of academic and practical research that supports this theory. The basic idea is that the mean of the aforementioned variables roughly represents, in the long run, the natural equilibrium of the economy. The question really is when the reversion will occur and not if. Intuitively, the further away those three variables are from their mean, the greater the chance of a recession or recovery. For example, based on the last 50 years, Jason Cawley calculates the mean of the unemployment rate, inflation rate and yield spread to be 6.4%, 3.7% and 0.95% respectively. Currently, the unemployment rate is 4.4%, the rate of inflation is 2.0% and the yield spread (ten-year treasury yields less two-year treasury yields) is 0.95%. Thus, the yield curve and the inflation rate are about where they ought to be but the unemployment rate is a concern. Jason Cawley contends that the risk of a recession is elevated when the spread tightens to 0.50%, the unemployment rate reaches 4.0% and the inflation rate climbs to 3%.

If the Fed is right that full employment has been achieved, then a strong case can be made that core inflation will significantly rise in about six to twelve months, which will move interest rates up several notches.

On the other hand, if the Fed is wrong that full employment has been achieved, then a strong case can be made that core inflation will stand still and no material increase in interest rates will occur.

In our opinion, the U.S. economy is not at full employment. The U.S. economy is behaving mysteriously. Usually wage growth accelerates when the job market tightens. Average hourly earnings of all private non-farm workers grew just 2.4% over the past year compared with an annual rate of 4.5% the last time the jobless rate was this low. Société General recently made an interesting observation: if one were to exclude the earnings of upper management, the average hourly wage rate is only 2.2%. What has happened to this historical and seemingly logical link between unemployment and wages? This line of reasoning is not as convincing as the Phillips curve theorem holds. Many things have changed and the link is not as tightly linked as it used to be. Significant changes include:

1. The bargaining power of labor has weakened with the decline of unions, the advancement of technology and the spread of globalization.
2. The abundance of goods and services has kept the rate of inflation below the pace of wage hikes, pushing workers to settle for small raises. The amount of certain goods, like information, is practically unlimited, rendering the method of allocating scarcity through supply/demand obsolete.
3. Many companies are making do with the workers they have through in-house development and training programs. Remembering the "Great Recession of 2007-2009," many workers consider themselves lucky to have lower-paying jobs.
4. Productivity has been weak, forcing companies to be resistant to wage increases to protect profit margins. The industry has not made a great effort to invest in modern equipment and software to boost productivity.
5. There is slack in the labor market. Labor force participation is much lower than it used to be. Only 78.6% of people in the 25-54 demographic are employed. It was 80.3% before the last recession. In other words, the employment-to-population ratio is 60% less than the 65% registered 15 years ago. This has created a sideline effect serving as a hidden reserve of labor. Moreover, the population is now healthier. Sixty is now the new fifty and seventy is the new sixty.
6. The gig economy has broken a fundamental link in capitalism. Pay rates no longer move upward as unemployment moves downward. This is due to companies like Uber and Just Eat, that can switch labor demand on and off very quickly. Many new entrants are making a living off Amazon, eBay, Airbnb, Etsy, etc.…
7. A big portion of the increase in employment has been in poorly paid, part-time, self-employed and low quality jobs.

There's a saying in economics, "It takes a theory to beat a theory". The miraculous thing about economics is that it often has explanations for anomalies that deviate from universal and standard theory. Economists use pattern-matching rules of thumb called heuristics. These are mental shortcuts, not perfectly accurate, but they do

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possess some explanatory power. We spotted several explanations. I particularly liked two of them.

The bottom line is that full employment is probably closer to 4.0% than the Fed's 4.7%. In this connection, the economy would need to generate 170,000 jobs per month over the next twelve months to achieve full employment. Jeremy Nalewaik, of the Federal Reserve Board, argued in a paper that the "Phillips Curve" is non-linear and has a very sharp bend. In other words, wage growth is unaffected until the unemployment rate falls below a certain threshold. Being in a regime of low inflation, the 4.0% just might be the threshold where wage gains begin to accelerate. It should be noted that there is another reason that can explain why the tightening of the labor market has not led to a wage rate acceleration. Neil Irwin, of the New York Times, suggests that the average worker's pay is essentially connected to productivity and inflation. The addition of productivity growth and inflation rate should equal the growth in wages paid to workers. It may sound a bit curve fitting, but empirical history supports the model. He wrote that "over the past 24 months, ended in March, inflation has come in at 1.4% a year, and productivity growth at 0.6%." In this simple model, one would expect average worker wages to rise only 2.0%. The latter number is low, but it may have risen too fast. For the period under review, average hourly earnings increased at the annual rate of 2.4%. Since 1966, average wages have grown more slowly than the Inflation-Productivity model would have predicted. Thus, workers are finally capturing more than their share of the spoils from a growing economy.

In conclusion, these new models collaborate with our base case scenario that the U.S. economy is in a two-plus-two nominal economic regime. That is 2% for growth and 2% for inflation. If the growth component will be made up of 0.5% for employment and 1.5% for productivity, future wages should turn in a 3.5 % increase in 2018. If our scenario proves to be correct, the federal funds rate should not cross the 1.50% level in either 2017 or 2018. Furthermore, we believe that the price of copper has not fallen enough from its recent peak, for it is still up 20% from last year and real interest rates, which are still very negative, have not risen enough to bring about a recession in the twelve months. As a matter of fact, High Frequency Models, like the ones used by the Federal Reserve Bank of New York and Atlanta, are tracking a 2.0% to 3.5% growth for the quarter ending in June, and all recession risk models that we follow are estimating that the probability of an economic fallout in the next twelve months is less than 10%. It's understandable that financial markets have become comfortable and complacent for growth, while low, is very stable and predictable; making risky investments remunerative on a recurrent basis. Returns have outdone risks. From the look of things, more of the same is to come. As long as the economy keeps on growing at the steady clip of 2.0% and with inflation around 2.0%, it would be a mistake to base market views on political ideologies. Developed countries have laws and institutions in place that make it almost impossible for anyone to radically change the direction of the political, economic and social order. Things change at a glacial pace. In this regard, one should look at the stock market as a gauge of business and consumer moods. Economic history demonstrates that bull markets tend to run until the next recession begins. We are not there yet. Moreover, a June interest rate hike is a good probability but not beyond June. At this time, Palos' quick and simple daily model, which is a function of copper prices, gold prices, real rates and yield spreads, predicts only one more rate hike in 2017

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