

June 8, 2017

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

Activity in Single Family Rental

The Palos Funds have been investing in US single family rentals (SFR) via Tricon Capital Group (TSX:TCN) for the past few years. On May 9, 2017, TCN completed its acquisition of Silver Bay Realty Trust Corp. The enterprise value of Silver Bay is approximately \$1.4 billion. On June 05, 2017, Colony Starwood Homes (CSH) announced that they were buying a portfolio of 3,106 SFR for \$815 million. After comparing the two portfolios acquired, we concluded that the TCN portfolio acquired was done at a higher discount. The CSA portfolio acquired has an implied gross yield of approximately 7.5% while that of the TCN portfolio is 9.0%. Our conviction is that the TCN acquisition has been further solidified by the substantial discount it was acquired at.

If we value the TCN SFR portfolio using the implied multiples of the CSH portfolio, we can easily value TCN at \$14 per share and it currently trades at \$11.80. We believe that TCN is still considerably undervalued relative to its peers.

In conclusion, we prefer TCN over many other SFRs as they concentrate on the middle market. It's important to note that the middle market is a more stable segment with a lower turnover. We see a great opportunity for TCN. There are many small portfolios out there that don't have the capital efficiency of TCN and are looking to monetize their investment.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	\$9.83	2.76%
Palos Equity Income Fund - RRSF	PAL 101	\$6.44	2.64%
Palos Merchant Fund L.P. (Mar 31, 2017)	PAL 500	\$4.13	1.36%
Palos IOU High Yield Fund (May 31, 2017)	PAL 701	US \$7.00	-3.83%
Palos WP Growth Fund - RRSF	PAL200	\$10.01	0.02%
S&P TSX Composite			2.06%
S&P 500			9.70%
S&P TSX Venture			4.01%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			3.58%

Chart 2: Market Data*

	Value
US Government 10-Year	2.19%
Canadian Government 10-Year	1.42%
Crude Oil Spot	US \$45.64
Gold Spot	US \$1,277.90
US Gov't 10-Year/Moody BAA Corp. Spread	224 bps
USD/CAD Exchange Rate Spot	US \$0.7403

* Period ending Jun 8, 2017

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■ What is New on the Macro Level?

By Hubert Marleau

On Pax America

Trump deliberately refused to honor Nato's article 5, opposed the current Nafta, abandoned the Trans-Pacific Partnership, neglected the Chinese Infrastructure Bank and is now withdrawing from the Paris Climate Accord. It's about time that the bottle be shaken. These moves, however, threaten the rules-based system of global governance to satisfy and placate populist discontentment resulting from soaring inequalities and gain short-term economic advantages. In the words of Mohamed A. El-Erian, the best way to understand these non-mutual actions is through the use of a simplified game of theoretics. Since the end of WWII, big global issues like international trade, international security, and climate change were addressed in cooperative ways. The world order in the West was cooperative as the players were able to form binding commitments with treaties, laws, accords or agreements. Under cooperative games, everyone wins albeit to a varying degree. Trump unilaterally decided that the game should be played in an uncooperative manner making conflict ever more frequent. Given that the US is a very powerful resource-rich country, one can deduct that the strategy can deliver immediate gains. For example, the transfer from fossil energy to alternative forms of renewable energy is very expensive, therefore there is a comparative advantage to be gained if one is to stick with fossil fuels; especially if a country like the U.S. has an abundance of it. I could make similar arguments when it comes to trade, security, finance and development. Why let others profit while I pay the price of restraint? I understand. But is it really what it's all about? I believe not.

What is unnerving is that the rest of the world could collude and we could find ourselves in a "prisoner's dilemma". A bad outcome, over the medium term, would mean that all countries end up in a worse situation than if they had cooperated. History is not very generous to isolationism because it has brought fragmentation, suspicion and selfishness. Game theory is clear on that one. Moving toward conflict rather than cooperation leads to untrustworthiness. The implications for trade, economic and geopolitical issues can turn into sorely irrational narratives and raise the following questions:

- Could trade partners put a carbon tariff on U.S. exports as a form of punishment?

- Could it be harder for U.S. companies to negotiate deals abroad, especially those involving the energy sector and sales of equipment and natural gas to foreigners?
- Could China take the lead and write the next set of trade rules?
- Could bilateral trade be renegotiated outside the WTO dispute settlement forum?
- Could the European Union set their own defense union and, in turn, replace Nato?

Most of us may believe that the questions above are impossibilities as globalization seems inevitable given that distances are shorter, national borders are dissolving and communication travels faster. We live in a single global marketplace for goods, services, capital and labor. Nevertheless, the pace of globalization can slow down if ideas and institutions that frame our politics fail. It's like a divorce, all parties are guilty and they all lose. Yet, life goes on. I trust that our world leaders will realign themselves with the new reality of the world order and exhibit a good second level of thinking so that we may continue to live in unison. What is most concerning is not so much the abandonment of the Paris Accord, but rather the possible end of Pax America resulting in a "fast and furious" entrance of China and/or Russia as vacuum fillers. What will make the world move on matters. And move on it will as the open-ended exponential growth of the world economy is resilient and never dies. This time, it may bring a lot more uncertainty, volatility and instability if U.S. intervention is missed, neglected or absent. The fact that this extraordinarily wealthy country has signaled to the rest of the world that its priority is purely economic could:

- usurp the U.S. role as the global forward-looking leader
- let others set global goals
- let them be deployed without U.S. consent.

I do not wish for the end of Pax America. It would be a step back from America's traditional role of dominance on world trade, international security and economic development and could bring about dangerous consequences. According to Moody's Analytics, global policy uncertainty is at its highest point in years.

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On Carbon Emissions

U.S. carbon emissions are set to decline even without participation in the Paris Accord. Indeed, the momentum towards cleaner energy may prove difficult to halt. Ultimately, it is not only about public sentiment and policies, but about technology. The energy transition is unstoppable because it is driven by technology. A force that is unstoppable irrespective of what any players decide. The renewable train has already left the station. The costs of wind, solar and energy storage are falling fast. The economics of energy are changing. According to Lazare Frère, a large NYC investment banker, utility companies can sign contracts for solar plus storage under 4.5 cents per kWh. They say that one cannot build a natural gas, coal or nuclear plant for that kind of money.

Moreover, the ongoing shift to natural gas for power generation to more fuel-efficient cars and the sworn commitment of states, cities and companies are factors that assure us that the lowering of carbon emissions will continue. Much of what has been pledged to reduce greenhouse gas emissions is already underway. According to the Rhodium Group and the Environmental Protection Agency, U.S. gross greenhouse gas emissions, in millions of tons of CO₂, equivalent under current programs will decrease from 7300 million in 2000 to 6200 in 2025.

On U.S. Monetary Policy

The Palos Monetary Policy Index, the composition of the Misery Index and the ratio of cyclical and interest rate sensitive expenditures to GDP are suggesting that more rate hikes by the Fed lie ahead. Moreover, key measures that track stress in the money markets are signaling loose financial conditions and the U.S. dollar has given up all its post-election gains. However, a lot of soft and hard economic data is showing surprising weaknesses, suggesting that there are considerable downside risks to growth and the chances of near-term tax cuts and fiscal stimulus, to boost business activity, have fallen. In this connection, we've changed our view on how and when, the Fed will raise interest rates. We now expect two rate hikes of 25bps, one in June and another in September. We no longer think that the Fed will hike rates by 50bps in June.

On a New Book

I just finished reading a book entitled "Scale" by Geoffrey West. It got me thinking about how it all works. The book argues that global sustainability is about scaling laws. It's a way of thinking that reveals that there is something simple, systematic and regular about this world. Everything lines up and is scaled in straight lines if growth is unperturbed by selfish disturbances. Geoffrey West is a theoretical physicist whose primary interests have been in fundamental questions on physics, biology and global sustainability. Time magazine considers him to be one of the top 100 most influential people in the world.

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