Issue 24

PALOS
INVESTMENT FUNDS

June 15, 2017

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Energy in The Dog House

Oil prices took a 4% nose dive on Wednesday after the bearish DOE inventory numbers were reported. The bears are definitely in the driver's seat, and any bad news can ignite an aggressive sell-off in the commodity. The DOE U.S. Crude oil Inventories reported a draw of -1661k and the market was expecting a draw of -2300K. A 4% drop seems a bit aggressive. However, when sentiment is considerably negative, panic selling is not uncommon. A sell-off in the commodity leads to a sell-off in the E&P's. We are quite selective in picking E&P stocks and ensure that specific criteria is met before inclusion into the funds. Discipline is especially important when there is negative sentiment in the sector and the underlying commodity is under stress.

To be included in our funds, an E&P name must meet the criteria below:

- Strong management team.
- Strong balance sheet; even under a stressed commodity price.
- A healthy Reserve Life Index (RLI)
- Low operating cost per barrel.
- Sustainable decline rate
- Capital discipline

If the E&P meets all of the above, the next step is to analyze the company's capital program. We prefer companies that are growing their production as it provides more flexibility in a challenging environment. Companies that are weak, will find that their only option is to decrease their capital budget which will lead to a decline in their production and serious financial problems down the road. We call this the energy quicksand. Here are a few names that fell victim to the quicksand:

- Baytex Energy Corporation (TSX: BTE): 2018 Debt/Cashflow 10.8x (production going from 68K to 61K by 2018)

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.62	0.57%
Palos Equity Income Fund - RRSP	PAL 101	$6.32	0.68%
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 - RRSP	PAL200	$9.73	-2.69%
S&P TSX Composite			0.40%
S&P 500			9.70%
S&P TSX Venture			1.43%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			3.64%

Chart 2: Market Data*

	Value
US Government 10-Year	2.16%
Canadian Government 10-Year	1.53%
Crude Oil Spot	US $44.46
Gold Spot	US $1,252.20
US Gov't10-Year/Moody BAA Corp. Spread	221 bps
USD/CAD Exchange Rate Spot	US $0.7537

* Period ending Jun 15, 2017

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- Pengrowth Energy Corporation (TSX: PGF): 2018 Debt/Cashflow 9.8x (production going from 44K to 39K by 2018)
- Trilogy Energy Corporation (TSX: TET): 2018 Debt/Cashflow 6.2x (production going from 23K to 19K by 2018)

The 2018 multiples imply that the above names are trading at a premium. In our opinion, the price charts are misleading investors into thinking that they are inexpensive.

The Palos quality names must meet the criteria listed above and have production growth. If growth is present, the company has the option to slow it down in a bear market. That way, even if production is flat during the period, the company will most likely be able to avoid a quicksand scenario. Here are a few names in our funds:

- ARC Resources Ltd (TSX:ARX): 2018 Debt/Cashflow 1.1x (production going from 122K to 142K by 2018)
- Seven Generations Energy Ltd (TSX:VII): 2018 Debt/Cashflow 2x (production going from 173K to 206K by 2018)
- Vermilion Energy Inc (TSX:VET): 2018 Debt/Cashflow 2x (production going from 69K to 75K by 2018)
- Whitecap Resource Inc (TSX:WCP): 2018 Debt/Cashflow 1.6x (production going from 57K to 62K by 2018)
- Spartan Energy Corp (TSX:SPE): 2018 Debt/Cashflow 1.3x (production going from 22K to 25K by 2018)
- Tamarack Valley Energy Ltd (TSX:TVE): 2018 Debt/Cashflow 1.4x (production going from 19K to 21K by 2018)

In conclusion, we strongly believe that you don't need to be a hero and don't need to take unnecessary risk. Markets are inefficient and an opportunity arises when there is a widespread sell-off. One should avoid charts and analyze fundamentals as they always prevail in the long-term.

Charles has been featured in the Growth Story Podcast by David Inzlicht. To listen, go to: http://bit.ly/GrowthStoryPodcast

■ What is New on the Macro Level?

By Hubert Marleau

On the U.S. Stock Market: Slow and Steady Wins the Race

Fair value is essentially a function of the level of profits plus growth prospects and the discount rate. Yet, many investors neglect the above formula and steer their thinking towards simple heuristic valuation metrics like the Price/Earnings multiple, Price/Book ratio and Price/Sales ratio. These metrics are elevated and are far-above their historical averages. According to a recent Bank of America survey, the majority of "value metric" followers think that the market is overvalued. While it is important to monitor these ratios from a historical perspective, these valuation metrics are not fool-proof determinants of fair value. They are static observations, non-adaptive to changing environments and, more importantly, do not pass the stringent scrutiny of academic research. They neglect the prospects for inflation, growth, monetary policy, interest rates, and the prospective risk of recession. As a matter of fact, the environment under which the market operates has undergone a major shift since the late 1990's. Growth has been softer, inflation slower and interest rates lower than in previous decades. Accordingly, the means and the averages upon which "value metric" cult observers rely, are unaware or cognizant that we underwent regime change. For example, P/E ratios have an average of over 23x since 1997, compared with only 14x in the preceding decades. It is crucial to know that investors' preferences and behavior tend to adapt to changing regimes.

If I was to assure you that the recession risk was very low, economic growth was sustainable at 2.0% per year along with a similar inflation rate combined with an even keel monetary stance, would you not buy stocks that have an earning yield of 5.25% rather than long term bonds that are yielding 2.15%? I think most savvy investors would opt for stocks. Bear in mind that real earning yields on stocks are 345 bps above the ten-year expected rate of inflation of 180 bps. Additionally, the equity risk premium presently stands at 330 bps in terms of forward earnings and 120 bps in terms of Shiller's CAPE. Indeed, retirees, who expect to live much longer, are sticking with equities for retirement because cash and bonds don't generate as much. The remarkable resiliency of the market is related to the perception that the current economic environment looks stable and sustainable. It explains why market corrections have been shorter and less frequent

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than what has been historically experienced. The last one was during the December/2015-February/2016 period when the drawdown in the stock market was more than 10%. Market pullbacks are viewed as buying opportunities.

The heuristics and conscious rules of thumb that frame our view of the economic environment may not be exact or optimal, but they do give us bounded rationality and, in turn, good enough information to predict the behavioral biases of investors. A few of the heuristics and rules used are listed below:

- Inflation: Consumer prices for core goods and services are 1.9% higher than they were one year ago. Given that increases in core prices are mainly affected by wage rates, there is a small chance that average hourly earnings will push up these prices well above 2%. As a rule, wage increases are related to changes in productivity and inflation. Neither one of these factors are strong enough to push wage rates well above current increases in core consumer price.
- Growth: High Frequency GDP Models based on the latest data suggests that the real growth is tracking an annual rate of 3.0%.
- Long Term Interest Rates: At the time of this writing, ten-year treasuries were yielding 2.15%. As a rule, riskless long-term interest rates should represent about 60% of the annual change in N-GDP. The latest reading implies that the the U.S. economy increased 4.0%, suggesting that long term rates could rise to approximately 2.40%.
- The Risk of Recession: The economic expansion is not in serious jeopardy. Various economic agencies calculate that the probability of falling into a recession, in the next six to twelve months, ranges from 9% to 13%.
- Monetary policy: The Fed is not tightening its monetary stance. The monetary authorities are normalizing their stance. It explains why the monetary authorities chose to increase interest rates on Wednesday while the inflation rate is declining. As a matter of fact, low inflation may deflate the fed's ambition and leave the mid-federal funds rate at 1.125% for the rest of the year. The Citi Surprise Index is falling and that should put a lid of long term bond yield at 2.25%. Current odds for another rate hike in 2017 is hardly 30%.

The aforementioned cognitive shortcuts strongly suggest that economic conditions are not expected to change the investment environment and, in turn, destabilize the emotional stability of the market. In our judgement, the EPS of the S&P 500, for the twelve months ending June 30, will come in around $120.00 and grow at a sustainable rate of 4.0% over the coming years. Without too much variance in the suggested 2.25% yield on long-term government bond yields, our model would suggest that the fair value is 2550. Unfortunately, there is plenty of political uncertainty and dysfunctionality arising from left and right-wing populism that could derail the undergoing moderation. One will never get a perfect all-clear get-in-now or get-out-now signal. In this regard, we watch Moody's Policy Uncertainty Index and it is high enough to be of concern. Matching the probability between economic prospects with government effectiveness is challenging. The latter looks a lot more like an unknown tail risk far outside the normal range of possibilities. That is why we follow, on a daily basis, the CBOE SKEW Index; a sort of black swan indicator. The index is currently at 136. Typically, the index oscillates between 100 and 150. The higher the indicator, the more investors are worried about an outlier event causing a market correction. In this connection, our portfolio managers are somewhat cautious, holding lesser amounts of risky assets than they normally do. It should be noted that geopolitical events are usually and quickly treated as non-events. The initial reactions can dry up liquidity, but history shows that it does not take very long for sanity to return. Making financial decisions in the face of international or domestic conflicts can be a wrong proposition.

On the Canadian Dollar

Our calculation of price differences between Canada and the U.S. shows that the fair value of the Canadian Dollar is 78 us cents. However, we've often argued in past commentaries that the Canadian exchange rate has been lower than it ought to be because of the deteriorating terms of trade, diverging monetary policy and different growth rates. In the past few months, the Canadian Loonie has fared better in the foreign exchange market because of the following:

- The performance of the Canadian economy is much better than that of the U.S. with less inflationary pressure.
- The terms of trade are slowly improving as many non-energy industries are benefiting from the comparative advantage of our undervalued currency.
- The Bank of Canada seems more amenable to the idea of reducing monetary stimulus. On

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Thursday afternoon, the Canadian dollar was trading for 75.25 us cents, up 3 cents from a recent low of 72.5 us cents.

In terms of numbers, the Palos Monetary Index, the composition of the misery index and the ratio of interest sensitive spending to R-GDP are mildly predicting that the Canadian monetary authorities should be a bit more hawkish and start to imitate with a lag the U.S. Fed. It is important to point out that Canadian employment is up 1.8% from last year while the increase in consumer price for core goods and services only increased 1.1% compared to 1.5% for the U.S. and with a 1.9% yearly increase in core consumer prices. These facts are not clear signs of what bias the Bank of Canada should have. Thus, we do not expect a rate hike at the July meeting unless we get a surprising increase in energy prices. The world oil glut is too large to depend on oil for major terms of trade improvements. There are a lot of short-sellers out there that see very negative implications for the Loonie arising from the presumed housing bubble. Yet, foreigners with long-term views are accumulating Canadian assets. In the four months ending April 30, foreign purchases totaled over $60.0 billion worth of securities.

On a New Book: Adaptive Markets

Andrew W. Lo, a professor at MIT and director of the MIT Laboratory for Financial Engineering, wrote an ambitious and wonderful book that answers fundamental questions in economics and finance. He manages to blend the modern financial theory that markets are rational and efficient with the behavioral finance theory that markets are irrational and inefficient into a new groundbreaking hypothesis that markets are adaptive to changing environment and conditions. He based his thought process on the science of biology like neuroscience and evolution. The book is essential reading for investors who want to know how the markets work. It is easy to read and has a quick flow.

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