Issue 28

PALOS
INVESTMENT FUNDS

July 13, 2017

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Rate Increase

On July 12, 2017, the Bank of Canada (BOC) raised interest rates for the first time in seven years and there is a high probability of a second hike by year-end. The income funds are well-positioned to take advantage of the new interest rate environment. Historically, the materials, industrials, and financials stocks outperformed the broader market under such circumstances.

The Palos funds have been increasing their materials exposure since the beginning of the year. Here are a few names that the funds are exposed to:

- Lundin Mining Corporation (TSX: LUN)
- Agnico Eagle Mines Ltd (TSX:AEM)
- Nutrien (NewCo Potash, Agrium) (TSX:POT) (TSX:AGU)
- Franco-Nevada Corp (TSX:FNV)
- First Quantum Minerals (TSX:FM)
- Trevali Mining Corp (TSX:TV)

For industrials, the funds are exposed to:

- Canadian Pacific Railway Ltd (TSX: CP)
- CanWel Bulding Materials Group (TSX: CWX)
- New Flyer Industries Inc (TSX: NFI)
- Boyd Group Income Fund (TSX: BYD-U)
- SNC-Lavalin Group Inc (TSX: SNC)
- WSP Global Inc (TSX: WSP)
- Waste Connections Inc (TSX: WCN)

For financials, the funds are exposed to Canadian Banks that have a Canadian focus such as the Canadian Imperial Bank of Commerce and National Bank. The fund is also exposed to banks with large deposits such as the Toronto-Dominion Bank. It should benefit from net interest margins (NIM) which will expand with rising rates. Lifeco's should also benefit from higher rates, Sun Life Financials and Manulife Financial Corp are our top picks in this space.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.42	0.59%
Palos Equity Income Fund - RRSP	PAL 101	$6.23	0.88%
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 $7.00	-3.83%
Palos WP Growth Fund - RRSP	PAL200	9.83$	-1.66%
S&P TSX Composite			0.48%
S&P 500			10.53%
S&P TSX Venture			82.32%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			3.83%

Chart 2: Market Data*

	Value
US Government 10-Year	2.35%
Canadian Government 10-Year	1.91%
Crude Oil Spot	US $46.05
Gold Spot	US $1,217.30
US Gov't10-Year/Moody BAA Corp. Spread	210 bps
USD/CAD Exchange Rate Spot	US $0.7858

* Period ending Jul 13, 2017

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■ What is New on the Macro Level?

By Hubert Marleau

The Bank of Canada Joins the Fed, Embarking on the Road to Monetary Policy Normalization

On Wednesday, the Bank of Canada increased its target rate to 0.75% for the first time in seven years. It did so ahead of other major central banks, on an improving economy that is eating up unused labor and industrial capacity at a "significant rate". The Canadian dollar is now trading just above its Purchasing Power Parity Rate of 78 US cents. Given that the Bank of Canada will likely follow the U.S. monetary stance and barring a NAFTA fiasco, the Loonie's future path will increasingly depend on what will go on in the Global Oil Complex. Interestingly, the Economist came out with its Big Mac Index, this Thursday morning, and printed that the Canadian dollar is worth close to 90 us cents. A Big Mac hamburger cost $4.66 in Canada versus $5.10 in the U.S.

On the Global Oil Complex

The OPEC agreement on oil production cuts has failed to end the three-year bear market for oil. The long-expected rebalancing of supply and demand is taking much longer than was generally believed. The rapid rebound of the U.S. shale industry and slower oil demand have prevented the efforts of the producers' cartel to sufficiently reduce the global oil glut. The global oil complex is not as flush as it was three years ago, but not enough has been drawn to restore a healthy balance. At this point, oil prices are range-bound between $45 and $55 a barrel, swinging back and forth, depending on who has the upper hand. A lot of attention has been paid to the recent cross-currents in the oil market. Oil traders reacted to the bullish effect of the production-cutting deal by OPEC and to the bearish effect of the boost in output by U.S. shale producers. The OPEC members made several mistakes and so has Wall Street. OPEC did not sufficiently cut production, failed to cut exports, allowed Libya and Nigeria to ramp up production and talk the market up way too much. Meanwhile, the U.S. shale operators got plenty of new financing and, in turn, increased their drilling and production activity. Wall Street injected $57 billion into the sector in the last 18 months. As a result, U.S. oil production increased to 9.4 mm bbl per day in June, for a 12% gain year over year. Oil inventories are way above their 5-year average. Many banks have begun to question the wisdom of Wall Street's investment choices.

The latter situation may be changing for cyclical production cost is starting to outpace secular productivity gains. If the marginal cost of shale oil was to stabilize around $45-$50 a barrel, an inflection point could erupt. Higher break-even points, combined with oil prices boxed in near current levels, could dry up money flows and force drillers to stop their expansion. Low crude prices are hurting the pockets of drillers. Under this possible scenario, incremental shale oil production could become difficult and permit the long-awaited rebalancing act to play out. Given that global oil demand is rising, particularly in emerging countries and also in the U.S., we could experience a rebalancing of supply of and demand in the second half of 2017. According to the Dallas Fed Energy Survey, the majority of oil executives expect the oil market to come into balance in 2018. It may explain the large premium that speculators and commercial buyers are willing to pay for future deliveries.

It should be noted that fortune favors the brave. People tend to place a lot of weight on the opinions of billionaires and hedge funds. It may be tempting to follow their lead, but they play a different game than the general population. They have more money, a shorter time horizon, a higher risk tolerance and assorted strategies. That is why we are not totally out of the energy sector for it may prove to be very foolish. Geopolitical risk indices are now at elevated levels relative to the last 100 years. Geopolitical instabilities and tensions have historically affected the oil markets. Moreover, "Rational Expectation Theory" tells us to be prudent and cautious for at the next OPEC compliance meeting in July, a decision to increase production cuts could come without any warning. A $10 rise in price of oil from current levels could happen in a fast and furious manner. Put simply, the longer oil prices are boxed in by automated algorithmic traders, the greater the chance that a nasty surprise could emerge. The driving factor behind this scenario is what's shaping up to be a three-year historic decline in investment and discoveries. World upstream oil and gas investment was down 25% in 2015, 24% in 2016 and probably another 3% in 2017. It's not that we are very optimistic about oil for the long-term for we can see an eventual world with less oil. But, we are interested in the short to medium term, and there are a number of factors that should be carefully watched. An awful lot of information is required to break a three year long negative narrative on oil. In this connection, we do not want

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to act prematurely. Accordingly, we are focusing squarely on identifying a potential inflection point for a narrative change would do wonders for oil prices. Factors to consider are:

- Global demand for oil, according to the IEA, is reassuringly stable. The world consumes 97 million barrels a day and an annual increase of 1.4 million is projected over the next five years.
- Multiple factors are making large oil discoveries rare. Reserve-replacement ratios have fallen to their lowest level in 70 years. This number is not likely to rise anytime soon. This is raising questions on whether sufficient reserves will be available in the coming years.
- The U.S. shale oil industry is not without problems. So far the breakeven point is stabilizing because most of the premier acreage has already been taken. The less productive fields have a marginal cost above $50 a barrel.

In conclusion, oil prices are depressed because the market did not get the quick inventory declines that it hoped for. As a result, there are large speculative short positions in the marketplace. In this connection, we shall look for clues and focus on the U.S. numbers like oil production, oil demand, imports and exports, rig counts and inventory levels in order to see new opportunities and take advantage of the current cheap entry point. Inexpensive energy stocks could shoot up if oil prices were to increase to $55 a barrel. As a matter of fact, energy share prices have been performing worse than oil prices. Nevertheless, we have no reason to think that oil prices could rise above $60 a barrel for any length of time. $60 a barrel is as good as it could get for the narrative calls for peak oil demand by 2025. Long-term oil contracts are starting to reflect this. In fact, the oil industry has been concentrated on activities that deliver shorter paybacks and streamline projects.

How We Predict Monetary Policy

Monetary policy should be viewed in the context of the time. Nevertheless, it is important to have a few heuristics to simplify the workload. Currently, the declining pace of inflation is a mystery for economic growth appears to be accelerating and the unemployment rates are edging lower. In this connection, the only reasonable answer to this conundrum is that the output gap between the demand for goods and services and the economy's ability to supply them is not narrow enough to push prices higher. Why? We think that there are two main reasons. Firstly, the labor participation rate is low and indicating that there may be more slack in the economy than presumed. Secondly, productivity gains are very low forcing management to cut expenses where they can and resist wage demands. Many businesses are either hiring workers on a part-time basis or introducing automation. The aforementioned context is contradicting many of our heuristics. But we continue to watch them for history shows that they prove right in time. Metrics of stock valuation are purely a function of profit levels, economic growth and interest rates. Therefore, it is crucial to have a fixing on monetary policy in order to calibrate, adjust and rotate investment portfolios with prospective changes in interest rates. Put simply, we monitor, on a weekly or daily basis, thirteen simple indicators that have outstanding results when viewed as a whole. They are not complex, do not go out of style, have causation, avoid over-thinking and filter out noise. The indicators we use are:

- The Palos Monetary Policy Index
- The Inflationary Composition of the Misery Index
- The Ratio of Cyclical Expenditure to GDP
- The Saint-Louis Federal Reserve Bank-Financial Stress Index
- The WSJ Dollar Index
- The Taylor Rule
- The Phillips Curve
- The Shape of the Yield Curve
- The International Spread of Bond yields
- The Inflationary Expectations of the Market
- The Atlanta Fed's High Frequency Economic Model
- Moody's Recession Risk
- The Money Supply and its Velocity versus the N-GDP

It should be noted that when most of these shortcuts point to the same direction and the context is right, there is a good chance that the right call will be made, giving investors ample time to adjust their portfolios with confidence. One may ask: "what is the right context?" We have discovered that interest rates are essentially a function of the changes in N-GDP. Assuming that the pace of the U.S. economy is expected to run at the annual rate of 4.0%, long-term government bond yields should trade no higher than 3.00% and federal funds rate no higher than 1.50%. Of the 13 indicators, all except two, suggest that the Fed ought to raise the policy rate twice in the next six months.

If interest rates and bond yields were to rise, it could change the notion that there is no alternative

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to risky stocks. It would depend on why bond yields rose. If it is because of inflation and/or normalization, it would be bad for stocks, but if it is because of growth it would be mildly good. I say mildly for valuations are already above average. Nevertheless, a strong economy would bring about higher future profits, that could offset the cost of discounting them to today at a higher rate. While I recognize the academic measure of the forward equity risk premium is flawed for it values stock like bonds, it nevertheless suggests caution. With a forward earnings yield of 5.65% and 10-year Treasuries yielding 2.40%, the gap of 365 bps represents the extra reward of holding the S&P 500. The gap is at a historical low and it could change the narrative if bond yields were to rise. In this connection, a prudent money manager may want to hold some cash as an option to buy risky assets later at better prices. Please note that the equity risk premium (ERP) is a recognized method and guide, but it does not hold much theoretical value. The ERP measure makes little sense since earnings are variable and should rise with inflation while bond coupons are fixed and static. Accordingly, there is no reason for the gap between the earning and bond yields to be at any particular level. Yet, the two yields are closely linked at times. Again, it will depend on the context. On Friday morning, the BLS will give us a new print on inflation. It may prove to be an important omen.

On a New Book: The Retreat of Western Liberalism by Edward Luce

Edward Luce, a columnist with the Financial Times, wrote a short book on what is happening to Western politics. It's a very easy read and full of insight with a penetrating analysis on what is going on and what has gone wrong. It does not take more than three hours to finish the book. He argues that the democratic west faces the danger of losing out to waves of populism and nationalism because of the erosion of middle-class incomes, the arrogance of the elite and the complacency about the durability of the system. He ends with prophecies that are not desirable if we share the opinion that liberalism is indispensable for economic freedom and societal advancement. The book is divided into four parts. The first part, Fusion, deals with the successes of globalization and the associate costs borne by the middle class in western countries. The second part, Reaction, describes the fall in productivity which accompanies the degeneration of politics. The third part, Fallout, is about the decline in Western hegemony to countries like China that have little sympathy for liberalism and freedom. The fourth part, Half Life, brings forth ideas to defend the world order and to restore liberal democracy.

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