Issue 33

PALOS INVESTMENT FUNDS

Palos Weekly Commentary

August 17, 2017

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■ Palos Funds

By Charles Marleau

The Tide Keeps Rising

On Tuesday, Tidewater Midstream and Infrastructure Ltd. (TSX: TWM) announced that it will be making the following two acquisitions for $51M:

- Deep Basin and Montney assets;
- 51% interest in a Wapiti Pipeline.

Both assets are in areas where E&P's are very active and demand for midstream services are high. The two acquisitions are expected to generate approximately $10M in annualized EBITDA, representing a 5x EBITDA multiple ($51M/$10M EBITDA). This is very accretive relative to TWM's pre-deal evaluation of approximately 7x.

The first acquisition included a few different assets. However, the most significant assets are an 85% working interest in Husky Energy 600 MMcf/d Ram River Gas Plant and a working interest in a pipeline that runs from Ansell to Ferrier. TWM believes that this pipeline will be of great importance for the Montney gas network.

The second acquisition is a 51% interest in the Wapiti trunk line, which is a 200km pipeline that stretches from Narraway through Wapiti.

The acquisitions will be financed with TWM's credit facility. This will increase TWM's debt to $121M or 1.5x Debt/EBITDA multiple. However, because the company is not issuing any equity, the acquisition is very lucrative on a per share basis

TWM and its management continue to surprise us with accretive acquisitions for which the market is not giving them the benefit of the doubt. As a result, TWM is trading at much lower multiples than its peers. We believe TWM has proven itself time after time. TWM has been carrying out its business plan and continues to make surprisingly accretive acquisitions. We believe the fundamentals and evaluation of TWM will reset upward as they continue to defy the skeptics.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.30	-0.71%
Palos Equity Income Fund - RRSP	PAL 101	$6.16	-0.32%
Palos Merchant Fund L.P. (Jun 30, 2017)	PAL 500	$4.22	5.65%
Palos IOU High Yield Fund (May 31, 2017)	PAL 701	US $7.00	-3.83%
Palos WP Growth Fund - RRSP	PAL200	$9.65	-3.52%
S&P TSX Composite			0.02%
S&P 500			9.96%
S&P TSX Venture			50.90%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			4.44%

Chart 2: Market Data*

	Value
US Government 10-Year	2.18%
Canadian Government 10-Year	1.85%
Crude Oil Spot	US $47.00
Gold Spot	US $1,286.40
US Gov't10-Year/Moody BAA Corp. Spread	210 bps
USD/CAD Exchange Rate Spot	US $0.7891

* Period ending Aug 17, 2017

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■ What is New on the Macro Level?

By Hubert Marleau

On the U.S. Stock Market

Numerous analysts and commentators are convinced that the stock market is due for a significant drawdown because:

- The S&P 500 index is printing new highs,
- Valuation metrics are elevated by historical standards and/or
- The boomers are retiring.

Caution is in order given the apparent high stock prices, ostensibly stretched valuations and visible complacency. Yet, it is our view that the market will react a lot more to the trashy verbal war between Trump and North Korea's Kim Jong Un than to fundamentals. As a matter of fact, politically related inflammatory rhetoric has not been a statistically significant driver of equity prices. Political, as well as other opinions that are not directly observable, can bring about dangerous conclusions. Why? We try to infer from them what analysts, columnists, politicians and strategists say, do and write. These observations are often proven to be inconsistent and contradictory over time. Thus, opinions are often wrong and imperfect. That is why Palos tries to stick with economic rules and sensible heuristics based on established data. In this way, we think that we can see if there are distinctions between the market and reality. We try to stay away from unsubstantiated statements produced by industry players who stand to gain from moving the markets. Trust is what investors must rely on the most. As such, a dependable process using reliable information is needed. The process must involve a robust set of simple and practical theories that have withstood the test of time and are hard to falsify. Also, numbers, like data and statistics, must be used for they are objective and non-judgmental.

About Stock Market Tops

The Dow Jones Industrial Average closed at an all-time high a few days ago and hit new highs 34 times in 2017. This represents a high number of all-time highs. 122 new all-time highs were reached in the period from 2013-2016. During the 1982-2000 period, there were 478 all-time highs. There is an old wall street saying that "markets don't crash from all-time highs". The fact is that there is nothing inherently bearish about all-time highs and they tend to be followed by more all-time highs. Benoit Mandelbrot, an expert in fractional geometry and chaos, observed that during all-time high days, volatility tended to be less than that of average days. He conclusively showed that forward returns are usually positive after all-time highs. Interestingly, data has shown that if an investor bought stocks at their all-time high, he would do better than someone who bought on average days. Of course, this phenomenon should not turn investors into perma-bull; but it does illustrate that bear market turns have to do with factors other than all-time highs.

About Valuation Measures and Metrics

The three popular metrics that investors follow to measure the relative value of stocks are: the twelve-month trailing P/E ratio (TPE), the twelve-month forward P/E ratio (FPE) and the ten-year cyclically adjusted P/E ratio (CAPE). When singled out and taken out of context, all three metrics appear to be rich based on their historical averages. It is crucial to examine each ratio in reference to the economic regime that influences the stock market. Moreover, these valuation measures are only part of the big picture and they should be examined alongside profit growth and financial strength.

Firstly, the TPE for the S&P 500 is about 22, which is high compared to the long-term average of 15.5. It should be noted that it was above 40 during the dot-com era and above 100 when the financial crisis broke. Moreover, a TPE of 24 does not look so bad when one considers the low level of interest and inflation rates. Investors can easily stomach earning yields of 4.55% when inflation is running at the yearly rate of 1.70% and ten-year Treasury notes are floating around 2.20%. Secondly, FPE, which is a much better way of looking at stock valuations since expected earnings are what investors care about, is 18 for the S&P 500 Index. It may seem elevated for single-minded observers. Yet, it is close to its historical average and certainly not excessive when viewed in relation to expected inflation. Expected earning yields are currently 5.50% and bond players are betting that the future rate of inflation will not exceed 1.75% over the next five years. An anticipated extra rate of 3.75% is worthy of consideration and sufficient to lure investors to take financial risk. Thirdly, the CAPE ratio was created by Robert Shiller, a renowned Yale economist. The idea is to reduce distortions that may arise from to time. The CAPE ratio now stands at 29.5, matching the level registered on the Black Tuesday of 1929, but below the level of 45 printed in 2000. In our judgement, the financial crisis was so severe that it drowned earning

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results. We prefer CAPE to using a biblical seven-year earnings average for it captures what is going on now and avoids events that are too far away to matter. In this connection, the five-year CAPE ratio is currently 23.5 compared to 18 over the long term. Again, earning yields calculated in this manner are 4.25% and which is 200 bps higher than ten-year treasury yields. Admittedly, people put a lot of confidence in the CAPE ratio; but it does not make the measure infallible. Back in December 1999, the CAPE peaked at 44.20 with earning yields of 2.25% while ten-year treasury notes were yielding 6.30%. In that environment, investing in stocks was a bad deal. Back in May 2007, the CAPE peaked at 27.6 with earning yields of 3.60% while ten-year treasury notes were yielding 4.75%. Another bad deal. Put simply, ten-year treasury notes would currently have to trade as high as 7.00% to be as bad an environment as in 1999 and 4.50% as in 2007.

About the Baby Boomers

A few months ago, Lightfield Capital came out with a thesis that the baby boomers will take down the stock market in the coming years because they cannot postpone divestments and must rebalance their portfolios from equity to bonds at a time when there could be insufficient inflow into equities. I think that the thesis is partially incorrect due to the following:

- Observations of older generations show that older people tend to spend less and try to stretch their investments;
- The employment figures show that an increasing proportion of the older population is working longer;
- Since age expectancy has risen, retirees are allocating more savings to equities to fund longer retirements;
- Potential inflows into equity could end up being much larger than anticipated. Millennials, corporations and foreigners could manifest a higher tolerance for risks and lower their assessments of risks.

How Long Will the Bull Run Last?

No one knows this answer because future stock market returns will be dependent on how investors will react to unknown data and imperfect information. Yet, we know from solid empirical evidence, valid economic theory and proven behavioral habits that 1) investors dislike recessions but love financial regimes where the cost of money is constantly lower than the rate of inflation and economic regimes where business growth consistently beats employment increases, 2) corporations also dislike recessions but love the comparative advantage created by the of relatively low exchange rates in their home currency and the favorable labor cost and tax rate arbitrage that globalization brings and 3) speculators also dislike recession but love financial machinations like situations where the cost of borrowing capital is less than the return on investments and money flows into the broad market without consideration for price discovery. Presently, it’s goldilocks for stock players for all the right conditions are in play for more capital appreciation and the recession risks are very low ranging from 9% to 18%. It’s not that dips such as 5% or corrections such as 10% are out of question or impossible. What is important to note is that bear markets are associated with imminent recessions. High frequency economic models that track data that is printed daily, are all showing a 3.5% annual rate of increase for the September quarter. In fact, it's not about where the valuation metrics are but rather the direction they take. Barry Ritholtz defines a secular bull market as an extended period, typically 20 years, that is connected to broad economic shifts that create an environment conducive to rising revenues and earnings under a regime where investment returns outshine the cost of capital and/or the cost of money is less than the rate of inflation.

Four Key Points to keep in mind:

- World Economic Research shows that the global economy grew 54 out of the past 55 years at the constant annual rate of 3.8%. In the words of AllianceBernstein, the world economy is back to normal. For ten years now, the global economy has been growing at 3.0% per annum as it was before the financial crisis. There is good reason to believe that the global expansion will continue. In global growth stakes, the U.S. and the Eurozone are economic plodders. Nevertheless, they are keeping a good pace given their potential, recording increases exceeding two percent in recent quarters. Japan grew at the fast pace of 4% in the June quarter with consumers and businesses driving six consecutive quarters of growth. China is still a powerhouse. The IMF raised its GDP growth for China this year from 6.2% to 6.7% and from 6% to 6.4% until 2021. It means that the official target of doubling 2010 Real GDP by 2020 is obtainable.
- This latter point could be very good for Canada. Investors will eventually recognize that Canadian fundamentals are changing for the better. Given the prospects for global growth, many of Canada’s problems,

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particularly with natural resources, will subside. In the other sectors, economic and financial fundamentals, outside of Toronto and Vancouver housing, are looking up. The differential between Canadian and U.S. forward price-to-earnings ratios are just too wide to persist. Something will give way. It may have already started for we see a lot of new money being committed to energy, financials and industrial sectors. The S&P/TSX is around 15150. We think that 16,500 a year from now is in the cards.

- U.S. Treasury yields are staying low alongside the probability of another rate hike in December, suggesting low inflation may keep the Fed's accommodative monetary stance in place. Herein lies a concerned risk for investors, a policy misstep from either the U.S. Fed or ECB. A policy misstep would be a continuation of tighter policy, beyond monetary normalization by the Fed or the start of an aggressive monetary policy by the ECB. This why Moody's global policy index is high. It would cause a bond rout and that would not be good for the stock market.
- Investors are bullish for they know that they are in a "goldilock era" but they are aware that tail risks are elevated. The CBOE index is very high. In other words, investors are going along with the momentum but are buying expansive protection against overcrowded trades like long tech stocks, short U.S.$, and long Eurozone equities.

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