Issue 34

PALOS
INVESTMENT FUNDS

August 24, 2017

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Did Someone Say Dividend?!

So far this quarter, two banks have reported their earnings and both have increased their dividend. Royal Bank of Canada (TSX: RY) raised its quarterly dividend by 5% to $0.91, which was higher than expected. CIBC (TSX: CM) raised its quarterly dividend 2.4% to $1.30 from $1.27. In general, over the past few years, Canadian banks have reported strong financials quarter after quarter. However, they are not getting much respect compared to their US competitors. It appears the Canadian housing market and Canadian debt levels have overshadowed the positive news from Canadian banks. Meanwhile, the Canadian economy is firing on all cylinders and even the province of Quebec is experiencing the best economic expansion and unemployment rate in 40 years. Defaults on mortgages and unsecured loans are usually correlated to unemployment and not to debt service and debt-to-assets, especially since most Canadian debt is mortgage related.

The negative sentiment is having an impact on valuations. Canadian banks are trading at an 8.9% discount to the Price to Earnings (P/E) of U.S Mega banks. Historically, they have traded at an average premium of 1.5% to the P/E of their US peers. Furthermore, Canadian banks are trading at the lowest premium in ten years relative to the Price to Book (P/B) of U.S. Mega Banks.

We believe Canadian banks are not getting the respect they deserve which creates an interesting investment opportunity. Palos has been slowly adding to its bank exposure and getting closer to the weight of the index. We believe that the Canadian housing market will contract in a controlled fashion and we have seen indications of soft landings in cities such as Toronto and Vancouver, where the housing market is significantly overheated.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.35	-0.12%
Palos Equity Income Fund - RRSP	PAL 101	$6.19	0.13%
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	$9.75	-2.46%
S&P TSX Composite			0.34%
S&P 500			10.39%
S&P TSX Venture			50.61%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			4.44%

Chart 2: Market Data*

	Value
US Government 10-Year	2.19%
Canadian Government 10-Year	1.89%
Crude Oil Spot	US $47.60
Gold Spot	US $1,286.50
US Gov't10-Year/Moody BAA Corp. Spread	212 bps
USD/CAD Exchange Rate Spot	US $0.7987

* Period ending Aug 24, 2017

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The Canadian banks are currently diversifying their business and geographic exposure. It may however take a few quarters for valuations to normalize. In the mean time, the funds are cashing in on some big dividends.

- CIBC trades at 9.6x P/E, and has a 4.8% dividend yield
- BMO trades at 11.0x P/E, and has a 3.9% dividend yield
- NA trades at 10.0x P/E, and has a 4% dividend yield
- BNS trades at 11.2x P/E, and has a 3.9% dividend yield
- RY trades at 11.6x P/E, and has a 3.8% dividend yield
- TD trades at 11.2x P/E, and has a 3.7% dividend yield

■ What is New on the Macro Level?

By Hubert Marleau

On the Global Oil Complex: The Short-Term Outlook

When OPEC and Russia first entered into an agreement to cut oil production, to clear the global oil glut, they believed that they were going to succeed within six months. The strategy did not work because the wrap-up plan is nine months later than originally anticipated. Moreover, the major oil producers will meet this coming November to decide whether they should prolong the plan. OPEC sources have indicated that they expect the agreement will be extended for another six months. According to the International Energy Agency, oil inventories will remain oversupplied until the end 2018. Several oil consultants think that draining the oil swamp may take several more years. The problem is that compliance is failing, U.S. production continues to expand, natural gas is replacing oil in various petrochemical products and oil consumption is slowing down. Given these observations, it may become problematic for OPEC to keep oil prices near the estimated marginal cost of $55 a barrel. The U.S. shale producers have been resilient and flexible as they are capable of producing more oil at a relatively low cost on relatively short notice. Accordingly, a reduction of oil-stocks down to the five-year average will require a lot more work for a good while longer.

Nevertheless, the re-balancing process is happening for oil inventories, which are still very high from a supply-demand perspective. They were lower in the second quarter than they were in the first. In a report issued last week, the IEA wrote that global inventories declined at a rate of 500,000 barrels a day. Moreover, the rise in the U.S. oil output may soon slow as energy firms cut rig drilling for new shale oil. A growing number of small and mid-sized oil companies are passing on expensive shale drilling projects. With crude oil prices under $50, many producers are losing money on what they pump. As a result, many projects are now favoring conventional wells. They are applying new technologies to vertical wells in old fields and spending no more than $1 million compared to the $6 to $8 million spent on the average shale well. Additionally, large oil companies are abandoning costly projects because oil prices are consistently staying below the marginal cost of producing a barrel of oil. They prefer to squeeze every available dollar from a barrel of oil by way of refining and short-term investments that generate faster profits.

Meanwhile, demand for U.S. oil is running around the annual rate of 2.0%. Consequently, U.S. commercial crude inventories have fallen 15% from their March peaks of 535 million barrels. The tightening of the market is expressed in the narrowing differential between spot and future contract prices. In this connection, oil stocks are out of favor. But if they weren't, oil stocks would have risen as much as 50% just to be in line with the broad indices. As a matter of fact, some of the big oil players are making huge financial commitments to the oil sector. For example, Total SA, a large French oil group, struck a $5.0 billion deal to acquire conglomerate A.P. Moeller-Maersk A/S's oil unit. There are a few good reasons to justify a rise in oil prices to $55 over the next twelve months. One big reason is that all 45 OECD economies are in sync and expanding simultaneously for the first time in a decade. However, the long-term outlook is unclear and problematic as many think that peak demand is far more likely than peak supply. This suggests that oil prices should not rise above the estimated marginal cost of $55 a barrel. Consequently, we are conservatively exposed to the oil sector. It should be noted that Palos is currently reviewing its long-term investment strategy to the oil sector; there will be more on this subject matter in future commentaries.

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