Issue 35

PALOS INVESTMENT FUNDS

August 31, 2017

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Hello!!! Propane!!!

Propane has been a sleepy commodity for the past few years and most investors have lost interest in it. However, the fundamentals have been changing in a very unnoticed manner by most. Ever since the US opened its propane business to the world via export terminals, things have been getting a lot tighter for the commodity. We're always on the lookout for opportunities such as this one where investors have thrown in the towel and driven valuations to compelling levels.

US propane inventories are 8% below the five-year average and prices are up 90% year-over-year, or roughly 30% since June 30, 2017. The demand for North American propane has been increasing as export rose by 150% since 2014. Our top idea is Superior Plus Corp (TSX:SPB), which has been growing its propane storage capacity for the past few years. SPB fills up their storage tanks during the summer months when propane prices are at their lows and release the propane during winter months at their high. months when prices are high. We think that SPB's propane business will be very lucrative this winter, especially given that inventories are already tight and prices are up significantly from the summer months. Making this investment even more compelling is SPB's 8.3x EV/EBITDA multiple relative to its peers and average Canadian midstream company trading at 11.8x.

■ What is New on the Macro Level?

By Hubert Marleau

On U.S. Monetary Policy

Classical economic theory stipulates that if monetary policy is loose when economic conditions suggest that it should be tight, either the inflation rate will rise and/or the exchange rate will fall. The notion is based on the fact that a central bank can control only two of the three main monetary variables: interest rate, money supply and the exchange rate. Under the current regime, only the exchange rate can float freely.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.55	1.93%
Palos Equity Income Fund - RRSP	PAL 101	$6.29	1.82%
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	$9.96	-0.36%
S&P TSX Composite			1.34%
S&P 500			11.93%
S&P TSX Venture			52.78%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			4.37%

Chart 2: Market Data*

	Value
US Government 10-Year	2.12%
Canadian Government 10-Year	1.85%
Crude Oil Spot	US $47.08
Gold Spot	US $1,322.90
US Gov't10-Year/Moody BAA Corp. Spread	216 bps
USD/CAD Exchange Rate Spot	US $0.8008

* Period ending Aug 31, 2017

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Consequently, the exchange rate is the variable that bears the brunt of a monetary stance that differs from what it ought to be.

In our judgement, the Fed should implement a relatively tight monetary policy. Firstly, the Palos Monetary Policy Index, which considers price stability, the viability of international trade, the employment situation and economic growth, stands above 200.0; a level that indicates that the monetary stance should be tight. Secondly, the inflationary content of the Misery Index, which is the addition of the inflation and unemployment rates, is above 25%; a level of inflation (1.7%) that is high enough relative to the unemployment rate (4.4%). Lastly, interest rate sensitive spending, like consumer spending on durable goods and business spending on investments and inventories, account for more than 25% of R-GDP; a proportional level of expenditure that is sufficient to keep in line with higher interest rates.

Meanwhile, the Fed has maintained a relatively accommodating monetary stance. Firstly, the yield curve, the differential between the cost of riskless capital (2.25%) and the cost of money (1.00%), is wide given the convexity of low interest rates. Secondly, the real cost of money is positive because the federal funds rate is about 65 bps lower than the current rate of inflation (1.70%). Thirdly, the transactional money supply with zero maturity is running at the annual rate of 4.5%, which is about 1.0% faster than the rate of increase in the N-GDP.

When one considers that there is no apparent financial stress, that economic activity is chugging along at a reasonable pace and the Fed's unwillingness to accelerate the move to a tighter monetary stance, it does not surprise us that the U.S. dollar is under downward pressure. The dollar index is down more than 10% since the end of last year. Should the Fed fail to raise the policy rates in December, the dollar could head much lower. In our view, the Fed will raise rates as it has few options, even though it may appear as though wage rates are not where the monetary authorities would like to see them. The factors that usually bring about wage inflation, like low unemployment, has faded away because of structural forces like 1) the integrated global value chains are not only creating disinflationary pressures but also abundance, 2) technology disruptions are causing a major supply-cost revolution and 3) changing demographics are replacing the older high cost workers with younger lower cost workers. These underlying forces key to inflation returns today and in the years ahead. There is growing evidence that the connection between unemployment and inflation is way overstated for the new global-technology-demographic regime. The Fed and the other major central banks are confronting the "coexistence of low inflation and unemployment," a phenomenon that inverts the experience of the 1970's, when inflation and unemployment were high. Accordingly, alternative theories have blossomed. New economic thinking is questioning whether wage growth is where it ought to be. A few months ago, I put together a straightforward model that has both theoretical validity and empirical evidence. It demonstrated that increases in average hourly earnings are a function of productivity gains and inflation. Put simply, gains in hourly average earnings are basically the addition of the inflation rate to productivity growth. History shows that the relationship holds up well. In the last two years ending June 2017, inflation has come in at 1.3% a year and productivity growth at 0.5%. Our model shows that the annual increase in average worker wages should have been only 1.8%, which is considerably less than the actual increase of 2.4%. Accordingly, there is evidence that the connection between unemployment and inflation is overstated given the new global-tech-demo regime. As a matter of consideration, one could even argue that average hourly earnings might be rising too fast, suggesting that the U.S. might be running at or near full employment. Credit Suisse came up with a model that is superior to our. Tim Duy and Marcus Nunes of Credit Suisse created a model that incorporates the unemployment rate with productivity and inflation. They calculated that the current below-average unemployment rate is adding 50 bps to wage growth. In other words, if the unemployment rate was, say the equilibrium rate of 5.0%, average hourly wages would be up only 1.9% year over year.

What Does It All Mean?

If the Fed knows what we believe it knows, one could reasonably assume that:

- the monetary authorities will hike the policy rate in December;
- the federal funds rate does not have to go much higher to keep inflation in check;
- interest rates are not going to go high enough to cause financial stress in the financial markets;
- rolling back banking regulation is far from a slam dunk.