Issue 42

PALOS
INVESTMENT FUNDS

October 23, 2015

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

Justin is not Pierre and Concordia Health is not Valeant

This week, the Canadian markets encountered two major events. Firstly, Justin Trudeau was elected as Canada's newest leader with an unexpected majority Liberal government. Markets generally reacted positively to this news. However, one sector in the Canadian markets, namely health care, has been under scrutiny. This sector currently represents 3.15% of the index, however, one month ago, it represented 5% percent of the index and was mostly attributed to one company, Valeant Pharmaceuticals International Inc. (TSX:VRX). VRX had been a darling for most Canadian investors and portfolio managers and was the main reason why the Canadian markets appeared to be doing better than it really was. The party came to an end when a Hedge Fund Manager, Mr. Martin Shkreli, bought the rights to a critical drug and hiked its price by 5000%[1]. His action brought tremendous attention to the sector, enough for Mrs. Clinton and Mr. Trump to question the process and procedures on how drugs are distributed. In all fairness, this behavior is outrageous and should be questioned. This placed a spotlight on highflying VRX, and investors and financial analysts began questioning VRX's distribution model and accounting reporting. One independent firm, Citron Research, is making serious allegations against VRX. The reason why VRX's distributions are being scrutinized is because the company uses specialty pharmacies to distribute some of their drugs, which bypasses traditional pharmacies and avoids generics that are often less expensive. How it works practically is the doctor writes a prescription for the medication with a phone number for the specialty pharmacy. The patient then calls and receives his medication, without knowing or being informed that there could have been a cheaper alternative. Speculators and investors are now

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.36	2.25%
Palos Equity Income Fund - RRSP	PAL 101	$6.29	2.10%
Palos Merchant Fund L.P. (Jun 30, 2015)	PAL 500	$5.82	24.13%
Palos IOU High Yield Fund (Sep 30, 2015)	PAL 701	US $8.98	8.23%
Majestic Global Diversified Fund (Oct 22, 2015)	MAJ 100	$0.00	-3.77%
S&P TSX Composite			-2.29%
S&P 500			2.47%
S&P TSX Venture			-20.56%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			4.74%

Chart 2: Market Data*

	Value
US Government 10-Year	2.09%
Canadian Government 10-Year	1.51%
Crude Oil Spot	US $44.60
Gold Spot	US $1,163.30
US Gov't10-Year/Moody BAA Corp. Spread	327 bps
USD/CAD Exchange Rate Spot	US $0.7595

* Period ending Oct 23, 2015

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questioning if this is viable, resulting in VRX being down 60% since September 2015.

The Palos Funds did not have any exposure in the health care sector until this week. Concordia Healthcare Corp (TSX:CXR) got caught in the crossfire and has fallen 70% since September 2015. However, CXR is not VRX. It does not use specialty pharmacies to distribute products and most of their drugs have price increases that are consistent with inflation. Palos had the chance to attend a call with the CEO of CXR and who gave us comfort that CXR is an investment opportunity as it is trading at a discount to its peers. The company is now trading at 25% free cash flow yield, at 7.1x EV/EBITDA 2016 compared to the group peer of 10.0x. Palos sees CXR as a great opportunity to step into the health care sector.

[1] http://www.alternet.org/economy/hedge-fund-manager-buys-rights-critical-drug-hikes-price-5000.

■ What is New on the Macro Level?

By Hubert Marleau

What Is Going On With Productivity in Advanced Economies Like the USA

Introduction

The aging populace, the public aversion to immigration and the lower birth rate are shrinking the workforce at a time when the latter is less willing to participate in the labour force. The coming labour shortage is expected to be a very acute issue. Companies and governments will have no choice but to boost efficiency if they wish to keep up with their competitors. The Boston Consulting Group (BCG) argues that unit labour cost will need to decrease in relative terms by as much as 25% by 2025 to remain competitive. Contrary to the opinions of economic quacks, robotics, big data, automation, energy efficiency and entrepreneurship are not the threats. There are real solutions to both social and economic problems.

The Definition of Productivity

For economists, productivity is defined as economic output per hour of work. Palos believes that efficiencies ought to show up in the general economy. In this connection, Palos divides Real GDP by total employment to estimate productivity. It's just simpler to calculate.

Something Has Changed

Three long lasting forces are at work: the falling productivity growth, and two similar decoupling phenomena - productivity and wage growth, plus productivity and employment growth.

(a) The Falling of Productivity Growth

The labour productivity growth peaked around 2002. Prior to 2002, productivity was growing at an annual pace of 3%, however it has been falling ever since. Productivity growth during the current expansion is averaging a 1% annual rate, the worst for any expansion since the 1960’s. As a rule, businesses have been reluctant to invest in fixed capital formation for the last 15 years and the efficiency of capital has considerably deteriorated over these years. Firstly, the growth of the capital stock of businesses which comprises business investment is plant and equipment and intellectual property such as R&D has not kept up with the potential growth of the economy. The capital stock grows only when gross investment is larger than depreciation allowances. According to Andrew Smithers of the Financial Times, the additions to the capital stock as a percentage of GDP averaged 3.3% for the longest time. This ratio has declined since 1999 and has recently turned negative. Secondly, it appears that capital has become less efficient. Many innovations like smartphones, tablets music and film streaming services and applications are great at curing boredom but only marginally improve productivity. Efficiency is measured by the incremental capital output ratio (ICOR), which is calculated by dividing the proportion of GDP that is invested by the growth rate of the economy. Today, it requires an increasing proportion of GDP to be invested in order to produce a given increase of 1% per annum in GDP. According to a study published by the Deutsche Bank, capital expenditures would have to increase by 8.4% a year to get a 2.0% potential growth in the 3 years or 6.2% to get there in 5 years. As an aside, it explains why capital is so valuable. A lot is needed to make the economy go forward. That is why stock market valuations are where they are.

(b) Productivity and Wage Growth

Between 1973 and 2014, the productivity of workers grew by 72.2% (or, 1.3% per year while workers’ hourly compensation increased by 9.2% (or, 0.2% per year). There are two reasons why this apparent inequality occurred. Firstly, capital has become more needed than labour, as a lot capital is needed to generate growth. Secondly, people can only earn more if they improve at producing more goods and services. Barring mensa members and people with ironclad work ethics or entrepreneurial qualities, it’s all about education. A key measure of human capital is education. The National Center for Education Statistics recently reported that only 34% of American have completed college and less than 8% have a master’s degree or higher. In fields like

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technology, finance, science and creative administration as well as professionals, a 4.0% wage growth is very common.

(c) Productivity and Employment Growth

For decades, productivity and employment rose in lockstep. From 1953 to 1999, average growth in productivity was 2.1%, exactly the same as growth in total employment. Since 1999, productivity growth roll along at 2.1% while job growth slumped to an average rate of only 0.5%. It may be related to globalisation and technological advances. But there is another big reason. People do what they need to do on their own. With the internet, consumers book their own flights, buy their own tickets, do research on a whole variety of things, make hotel and restaurant reservations, etc.

What's going on?

Advanced economies are strictly debt-based money system. It is critical to appreciate the dynamic of credit and how it relates to growth, productivity and inflation. All money is debt. A loan must be made to create money. Therefore, the issuance of loans is the same as the issuance of money. This how the system works. Basically, the money supply needs to increase more or less with population. So, if the population is growing at say 1.0%, money needs to grow at the same speed to finance growing expenditures. As workers become more productive, the economy will need more money again to purchase the newly produced goods and services. If one was to assume that in the future, productivity was to increase 1.5 % per year, as it is generally accepted that the money supply would have to increase by a similar amount. This is where it gets tricky. Because of a variety of reasons, it is difficult to determine what would be the consequences if productivity increases. Breakdowns in the diffusion machine, like regulations designed to protect the environment and/or undermined public and private sector investments, unfavorable government policies, lack of new business formation, regulatory lags and political bickering can affect what would be the normal process.

Nevertheless, we can rely on the following economic logic: productivity gains are either rewarded with more money and stable prices or with the same amount of money and lower prices. Where the economic logic will take us is crucial, but not easy to discern. Our take is that most of the productivity increase over the past 15 years has brought about lower inflation than it ought off otherwise brought. As a matter of fact, very little has found its way into wage gains.

In the past, productivity slowdown featured declining profit margins, rising inflation, higher cost of money and lower equity valuations. This time, the opposite happened. The quality and spread of technology has cut the workload of corporation as individuals are doing most of the work on their own. One just has to think about the zero cost for value that Google, Apple App's, Android and web surfing have brought us.

Unfortunately, a debt based money system needs some inflation to make the economy work. Falling prices or deflation is not good. In a debt-based money system, it must be relatively easy to pay off loans. In periods of deleveraging like we are currently having, where loans are paid back, the money supply is destructed forcing price inflation down.

This is the principal reason why central banks try to provide additional money supply by managing the very short term cost of money to assure an appropriate level of inflation. Having a target inflation rate of 2% is a way to keep prices from falling and to maintain stability. Acknowledging that about a third of the increase in the money supply is needed for processing financial transactions like buying stocks, bonds, commodities and their derivatives, the increased amount of money supply needed to work the economy today is approximately 4.5%. Currently, MZM is growing at the annual rate of 6.0%, a bit less than it ought to. Thus, if the above theory is somewhat correct, easy monetary policy is here to stay.

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

Chart 3: Palos International Fund (Total Returns)*

	Last	YTD Returns
Palos International Equity Income Fund PLC - CAD	CA $4.90	-3.61%
Palos International Equity Income Fund PLC - EUR	EUR 5.87	-7.16%
S&P TSX Composite - CAD		-3.13%
S&P TSX Composite - USD		-13.48%

* Period ending Oct 13, 2015