Palos Weekly Commentary

PALOS INVESTMENT FUNDS

February 9, 2017

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■ Palos Income Fund

By Charles Marleau

Canadian Energy Sell-Off

Canadian energy equities have been going through a correction since mid-December 2015. The iShares S&P/TSX Capped Energy (TSX: XEG) has been down approximately 12% since December 15, 2016. We therefore see an opportunity in high quality intermediate E&P’s.

Below are several high-quality intermediate E&Ps and their performance from December 15, 2016 to February 7, 2017:

- Whitecap Resources Inc (TSX: WCP) down 14.7%
- Arc Resources Ltd (TSX: ARX) down 18.2%
- Crescent Point Energy Corp (TSX: CPG) down 20.9%
- Birchcliff Energy Ltd (TSX: BIR) down 26.4%
- Tamarack Valley Energy Ltd (TSX: TVE) down 9.6%
- Seven Generation Energy Ltd (TSX: VII) down 16.7%
- Tourmaline Oil Corp (TSX: TOU) down 18.2%
- Raging River Exploration Inc (TSX: RRX) down 16.5%

We have been adding to these names while simultaneously reducing our exposure by shorting XEG, also known as a pair trade. By using this strategy, the fund is reducing its industry risk as we are shorting the whole energy sector via the ETF. In addition of being attractive in terms of statistical correlation, the fundamentals of these high-quality companies are also very attractive in comparison to their lower quality peers. We believe that the market will start noticing the opportunity and that this window will be short-lived.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.90	1.43%
Palos Equity Income Fund - RRSP	PAL 101	$6.47	1.37%
Palos Merchant Fund L.P. (Sep 30, 2016)	PAL 500	$4.60	-13.07%
Palos IOU High Yield Fund (Dec 31, 2016)	PAL 701	US $7.46	-0.26%
S&P TSX Composite			2.37%
S&P 500			3.29%
S&P TSX Venture			8.34%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			1.79%

Chart 2: Market Data*

	Value
US Government 10-Year	2.39%
Canadian Government 10-Year	1.68%
Crude Oil Spot	US $53.14
Gold Spot	US $1,227.20
US Gov't10-Year/Moody BAA Corp. Spread	225 bps
USD/CAD Exchange Rate Spot	US $0.7606

* Period ending Feb 9, 2017

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■ What is New on the Macro Level?

By Hubert Marleau

On Productivity: It May Have Turned

Last week, we alluded to the growing probability that productivity trends may have turned the corner for the better. We calculate labour productivity without consideration for hours worked and the proportion of workers that are employed part time. In doing so, accuracy is somewhat compromised, but it is compensated with speed. Several weeks ago, we were able discern that the productivity trends were improving for the better. The official numbers on productivity were printed by the Bureau of Labor Statistics a few days ago, and they conclusively showed that there have been improvements. In the fourth quarter of 2016, productivity was 1.1% higher than it was in the comparable period of 2015. It was the first year over year increase in a long time. As a matter of fact, productivity increased during the last two quarters. The new growth trend in productivity is running at the annual rate of 1.0%. There are several reasons why productivity could rise even faster. Put simply, animal spirits are up, spending on intellectual property is up, financial and industrial deregulation is expected and corporate tax cuts are coming. This could not come at a better time as employment growth is expected to fall.

On Interest Rates: Why They Are Lower Than They Ought to Be

We've argued for some time, given the current economic trends, that long term government bond yields should trade around 3.00%. That is about 50 bps less than what would be considered normal and is caused by the favorable interest rate differential between the US and the Eurozone. For example, yields on ten year U.S. Treasuries are 200 bps higher than that of comparable German Bunds. The Fed's tighter monetary stance over the past 18 months has been replaced by asset purchases by the ECB and the Bank of Japan. In this regard, the money generated by these purchases is flowing into the North American financial markets and creating extra demand, which pushes interest rates lower than domestic markets would like. It is thus essential to watch out for the policy actions of the ECB.

On Market Velocity: The Vix Index, a Measure of Market Fear, Is Not Reflecting Political or Economic Anxiety.

Market volatility is dead and registering record lows. The S&P 500 has not had a 1% daily drop in 85 consecutive days. The second highest observation in ten years. It's a rare occurrence. Investors are optimistic as more capital is flowing into the equity markets. The percentage of investors who are bullish is the highest since 2007. The probability of a recession in the U.S., measured by the Federal Reserve Bank of Atlanta, Moody's and the Federal Reserve Bank of New York, is less than 10%. Market corrections are probable when the market runs too fast or metrics are too high. However, bear markets are rare when there is little risk of an upcoming recession. As a matter of fact, there is a lot of favorable cyclical evidence in the U.S. and around the world suggesting that the global economy might now be growing at a rate of more than 4.0%. The latter is based on Jim O'Neill, former chief economist at Goldman Sachs, and his six economic indicators that provide a reliable snapshot of what the global economy will look like in the next six months. Yet, disconcerting political events in the western economies, indicate that trade wars may be looming may be pushing investors to pay a lot to insure their portfolio against possible mishaps. In other words, investors are aware that they face possible shocks like the Trump presidency, Brexit and populist movements in Western Europe.

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