Issue 25

PALOS
INVESTMENT FUNDS

June 22, 2017

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

The Marriage is Approaching

Potash Corp (TSX:POT) and Agrium (TSX:AGU) announced that the combined company will be called Nutrien. We are expecting the marriage to be finalized in the third quarter of this year. Once combined, Nutrien will be the global leader in reliable, low-cost crop nutrient production, combined with the largest agricultural retail-distribution network in the world. We are not expecting any recovery in fertilizer prices in the short-term. The attraction of the combined company comes from the potential synergies and future free cash flow growth. Even if fertilizer prices are flat, we are expecting free cash flow to grow by 40% in the next 4 years as synergies are achieved. Management has indicated that it expects approximately $450 million of synergies to be created. Once combined, Nutrien will be a free cash flow machine, which is why we are expecting a 4% dividend from day one. Furthermore, we are expecting growth capex to be low for the next two years. The potash division is running at 50% capacity, Phosphate at 80%, and nitrogen at 85%. Hence the high dividend. We are forecasting its net debt/EBITDA going from 2.9x to 1.6x by 2019. For the Income funds, we see the combined company as a great source of investment income with the opportunity to benefit from a recovery in fertilizer prices and a growing retail segment.

Charles has been featured in the Growth Story Podcast by David Inzlicht. To listen, go to: http://bit.ly/GrowthStoryPodcast

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.65	0.96%
Palos Equity Income Fund - RRSP	PAL 101	$6.36	1.27%
Palos Merchant Fund L.P. (Mar 31, 2017)	PAL 500	$4.13	1.36%
Palos IOU High Yield Fund (May 31, 2017)	PAL 701	US $7.00	-3.83%
Palos WP Growth Fund - RRSP	PAL200	$9.77	-2.35%
S&P TSX Composite			0.82%
S&P 500			9.81%
S&P TSX Venture			1.35%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			3.49%

Chart 2: Market Data*

	Value
US Government 10-Year	2.15%
Canadian Government 10-Year	1.50%
Crude Oil Spot	US $42.79
Gold Spot	US $1,247.60
US Gov't10-Year/Moody BAA Corp. Spread	215 bps
USD/CAD Exchange Rate Spot	US $0.7556

* Period ending Jun 22, 2017

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■ What is New on the Macro Level?

By Hubert Marleau

Productivity: An Underappreciated Potential

Regrettably, productivity has been a discouraging factor for economic growth for a long time. Productivity gains were halved in the last decade compared with their average from WWII through 2006. From 1950 to 1970, U.S. productivity grew on average by 2.6% annually. From 1970 to 1990, it fell to 1.5%. Since 2010, productivity growth has been in a free fall growing at only 0.6% per year. Because of this long history of falling productivity gains, investors are now subscribing to the school of thought that secular stagnation is never-ending. Put simply, since the recovery began in 2009, GDP has grown by only 15% compared to 45% for the expansion of the 1960s and 28% for the Reagan recovery. The thing is that humans tend to respond eagerly to pessimism and tend to coddle it for long periods. Why? During the past 20 years, investors made money mainly with money and not by investing capital in real investments for profit. The latter is a chronic and systemic inhibitor that has not only contributed to inequality but has also largely reduced the turnover of money, forcing the Fed to hold interest rates low to compensate the banking system with money supply increases to maintain adequate spending. Unfortunately, having rapid growth without reasonable productivity gains means that society must be willing to tolerate the financial recklessness that goes with it. In other words, without productivity, one can either have financial stability or economic expansion, but not both. No wonder Janet Yellen calls low productivity a “significant problem”.

In this respect, productivity better increase soon, otherwise society will not be able to raise living standards and prosperity. Rising debt levels, degradation of the environment and rising dependency ratios will result in huge future costs. For example, in 1970 there were 5.3 workers for every retired person, by 2010, this metric had fallen to 4.5, and should decline to 2.6 by 2050.

Yet, history shows that humans can powerfully amend their condition. Historical facts prove that we have the abilities and resources necessary to change the past for a better future. Daniel Kahneman wrote that “organisms that treat threats as urgent have a better chance to survive and reproduce”. Economics teaches us that in the fullness of time, and for as long as we stay competitive and ambitious, business moves away from what is unsustainable and toward technological improvements and new ideas. However, the process is more incremental than transformative until it broadens. The Manhattan Institute suggests that they are observing patterns of multifactor productivity growth, implying a looming second wave of productivity growth driven primarily by the technology sector, which includes areas such as artificial intelligence, digitalization and robotics. Research at the Institute argues that the pace of innovation in the technology sector is moving fast and broadening as of late. This is good news for productivity. As a matter of fact, productivity will need to play a key role to drive GDP growth in the coming years. What lies ahead is promising as the firms are returning less money to shareholders in the form of dividends and share buybacks and, in turn, reinvesting cash in their businesses to increase productivity through the adoption of new technologies, acquisition of new equipment and additional training of employees. There are signs that indicate that productivity may have turned the corner. Our numbers show that productivity trends are improving and have clearly recovered from the low point of 0.3% in 2012 Q2 to 0.7% today. There are significant pent-up productivity gains. The collective impact of very advanced technologies like simulation, big data, the cloud, robotics, microsensors and 3-D printing could be pushing efficiency to a tipping point. In this connection, I would refer our readers to the following in-depth working papers:

- The Coming Productivity Boom by Michael Mandel and Bret Swanson of The Technology CEO Council
- Productivity: A Surprise Upside Risk by Matthew Tracey and Joachim Fels of Pimco

It should also be noted that the Treasury Secretary, Steven Mnuchin, has a GDP growth target of 3% for the U.S. economy. To achieve this objective, it will require a rebound in labour productivity to 2.25% per year because employment growth cannot do better than 0.75% a year from here on.

On Monetary Policy

The thoughts on what the Fed’s future monetary stance will be are changing because there is increasing concern about recent soft inflationary signals and many new data points are negatively surprising. These new prints might be transitory. However, we are noticing that all high frequency models, that track the path of upcoming economic growth, are weakening. Our searches show that demand for oil, homes and cars are either down

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from a year ago or have slowed down in recent months. Something is affecting the demographic environment, social spending behavior and business habits and is producing a growing disbelief in the economic orthodoxy that strong labor markets should quicken price pressure. In the past few weeks, I argued that wages are a function of productivity increase and inflation. In this connection, wage gains should not increase any more than 2.2% per year. Yet, average hourly earnings are up 2.5%. Indeed, an interesting observation! I'm not sure what to make of it. Either inflation cannot rise much above the Fed's target of 2.0% or a tipping point has been reached. We are closely watching the data points on inflation. At this time, the bond market seems to be indicating that the former is the case.

On the Global Oil Complex

The oil sector is not the giant industry it once was. Crude oil entered a bear market last Tuesday meaning that it was down more than 20% from its recent high. Many believe that oil prices are in a downtrend and that the possibility of them trending lower is probable. The WSJ had an article in the section named "Heard on the Street" that suggests that there is new hope and that oil will probably avoid a fall back to 2016 lows. In 2016, oil prices touched $26 a barrel. Nathaniel Taplin argues that Chinese demand is too strong, hovering around the 3% mark year over year. Meanwhile, US supply growth appears to be headed towards a peak, U.S. inventories are heading lower, the number of active oil rigs has turned and the peak driving season is approaching.

On a New Book: Grave New World - The End of Globalization

Stephen D. King, a senior economic advisor with HSBC and a specialist adviser to the Treasury Committee of the British House of Commons, wrote a convincing, provocative and thoughtful book on current geopolitical issues. He provides an account of why globalization is being rejected, why the new political narratives are about them-and-us, why protectionism has re-emerged and why many are willing to sacrifice global growth for national interests. He thinks that history will return to what it used to be: Rival states, with conflicting agendas, will rule the world and cooperation will be hard to come by; an unwelcome return!

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