Issue 26

PALOS
INVESTMENT FUNDS

June 29, 2017

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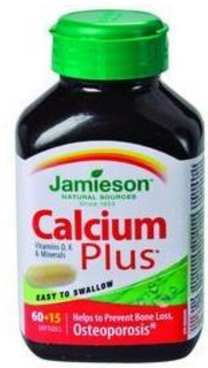
Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Take Your Vitamins



If you have never seen this product, I don't know where you shop. Jamieson Wellness is the leading Canadian vitamin company. Its products are distributed in every major food retailer, drug stores, health food stores and can even be purchased on Amazon. Jamieson's market share is approximately 2.5 times greater than its largest competitor (Centrum). The company and its brand is clearly the leader in the Canadian vitamin market.

The North American vitamin industry will continue growing due to aging demographics. Sport nutrition will also continue its growth trajectory as health awareness continues to be more important to the general population. The company also has a strong research and development department which has led to a strong track record of new products. Furthermore, the product innovation is complementary to its international business. We see significant growth internationally as products can be tailored to the specific concerns of that country. For example, Jamieson has been successful with Super Liver Detox, Power for Men and Lung Health Support in China.

The company is also well-positioned to optimize its manufacturing and distribution channels. The firm's operations are also scalable with modest capital investment. As the international business scales up, we are expecting to see margin expansion. We also view acquisitions as a growth strategy as the company can easily utilize its

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.68	1.25%
Palos Equity Income Fund - RRSP	PAL 101	$6.37	1.45%
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	$9.82	-1.78%
S&P TSX Composite			0.94%
S&P 500			9.17%
S&P TSX Venture			0.25%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			3.64%

Chart 2: Market Data*

	Value
US Government 10-Year	2.27%
Canadian Government 10-Year	1.71%
Crude Oil Spot	US $44.93
Gold Spot	US $1,246.00
US Gov't10-Year/Moody BAA Corp. Spread	213 bps
USD/CAD Exchange Rate Spot	US $0.7689

* Period ending Jun 29, 2017

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operating expertise to optimize synergies and margin.

Jamieson is a perfect investment for the Palos funds as it generates significant free cash flow and will also have a good balance sheet post-IPO. We are of the opinion that Jamieson has significant organic growth and many acquisition opportunities. That is why we believe there is growth potential beyond the 2% expected dividend. The company's valuation is fair and margins are healthy and expected to scale as the international business ramps up.

■ What is New on the Macro Level?

By Hubert Marleau

More on Productivity: An Underappreciated Potential

Last week, I boldly argued that corporations, over the past decades, have made more money for their shareholders by paying dividends and buying back share than by investing in fixed capital. According to our rough calculation, the capital stock of American business totals about $36.0 trillion---it's the amount that businesses plowed into fixed capital formation over the last 12 years. Assuming that 60% of this spending was funded with debt and 40% with new issues and retained earnings, the current return on equity is around 10.0%. Presently, after-tax corporate profits are around $1.4 trillion. Interestingly, the S&P 500 has an earning yield of 5.25%. In other words, the return on physically invested capital is better than what the market provides. It leads me to believe that corporations may be inclined to defy the old rules of satisfying shareholders and take advantage of the price premium offered by the market. It follows that such actions would boost investments and productivity.

On Canadian Monetary Policy

The Bank of Canada has publicly stated its intention to change the direction of Canada's monetary stance because it has confidence in the economy and believes that the oil shock is over. We do not give much credence to this announcement as the economic data does not support such a change, even though normalization would help to soften the presumed housing bubbles, give the central bank some latitude and possibly dampen the rise in household debt. When one stops to think about the incomprehensible rise in housing prices combined with high household debt, you might think that a problem is looming. One has only to look at the savior of Home Capital. There are some good folks out there who think that the Government of Canada got involved in this one. They know that monetary policy does not have much to do with bailouts. A higher level of intervention is needed to halt potential panics. Well, Buffett did it again! What is amazing is that the Bank of Canada Housing Affordability Index sits at 0.346, which is cheaper than the historic norm. Currently, the index is about half way from the lowest point (0.29) after the last recession and the recent peak (0.391) printed in the fourth quarter of 2007. The quick rise may be the reason why housing prices feel expensive. So, what is the big deal? In our judgement, the Bank of Canada is under some pressure from the BIS, an organization of leading central banks, to accelerate monetary normalization. The BIS argues that if central banks are too late to moderate accommodation, it will become very difficult, even impossible, to accomplish normalization; particularly if inflation was to suddenly flare-up, a contraction phase was triggered, protectionism became widespread and the bullish financial cycle was to abruptly end. In its latest report, the BIS pointed out that the central banks should be aware that there is a disconnect between measures of policy and geopolitical uncertainty and measures of market volatility.

The Palos Monetary Policy Index, which considers the pace of inflation, the viability of the balance of payments, employment and growth, has fallen fast and furiously in the last few weeks. It now stands at 95, down from 122 on May 10. The Index suggests that the monetary stance should be tight when it's above 120, even keel or neutral when it's near 100 and easy when it's less than 80. Moreover, the inflationary composition of the misery index is only 14% down from 24% at the beginning of May. The Canadian economy performed well during the first quarter of 2017, increasing at the annual rate of 3.7%. A big part of the increase was tied to the real estate sector. High frequency economic models are tracking much slower growth for the June quarter. The best one can expect, at this time, is 1.7%. These numbers strongly suggest that the Canadian monetary authorities should stay put and practice an even keel posture. Should the Bank of Canada decide to raise interest rates when it ought not, the Loonie would head toward its purchasing power parity rate, which we calculate to be 0.78 us cents. On Thursday morning, the Loonie was trading for 0.767 us cents.

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On a New Book: The Rise and Fall of Nations

In 2012, Ruchir Sharma wrote a book entitled "Breakout Nations" and it's widely acclaimed as the best book ever written on the economic landscape in the rest of the world. He very recently wrote an updated book and it is nothing less than a brand-new guideline for the global economy. It should be noted that the book, The Rise and Fall of Nations, is an investor-business view of the world and a useful guide for portfolio managers that shift and move money around. He is part of the mythical "low growth" trap. He claims that we are currently stuck with four major negative forces. These are: de-population, de-leverage, de-democracy and de-globalization. Yet, he offers a framework for thinking about emerging countries. He insists that a country's prospects rise and fall over cycles of up to ten years. The author likes countries that are at the beginning of a rising cycle and meet all or most of the following criteria:

- stable debt
- low inflation
- a cheap currency
- little government interference
- invest in infrastructure
- good billionaires that create businesses, not cronies
- incorruptible leaders
- a business and political culture that rewards merits and risk-taking rather than seniority
- lack angry populism
- open to trade, immigration and investable capital.

On Homeownership

Ben Carlson, director of institutional asset management at Ritholtz Wealth Management, has a common-sense opinion on home ownership. He wrote in the National Post, "Over the long haul, it's hard for homes to compete with the stock market in real appreciation. That's because companies retain a good share of their earnings to plow back into the business. The business should grow through time. By contrast, real home prices should decline with time because they wear out, go out of style and require repairs, improvements and maintenance. The problem is that the home-buying experience is fraught with emotion. People rarely think about the characteristics of real estate as an investment when putting down roots and making the biggest purchase of their life. Once the herd mentality sets in, these things take on a life of their own".

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