Issue 27

PALOS
INVESTMENT FUNDS

July 06, 2017

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

SNC-Lavalin Is Now on Top of The World

On July 3, 2017, SNC-Lavalin Group Inc (TSX: SNC) announced that it successfully completed its acquisition of WS Atkins PLC (Atkins). When combined, the firm will become a global player. The combination will enhance its presence in the rail, transportation, nuclear and energy infrastructure industries all over the world. It will also allow SNC to expand its tentacles into new geographical markets where it is not currently present and create cross-selling opportunities; which should lead to selling and revenue synergies. We are excited as this acquisition starts a new chapter for an old legacy business that needed a bit of a jolt. We are confident that SNC will be able to execute on the synergies as it has a track record of over-delivering on these types of transactions. For example, when SNC acquired Kentz, they successfully achieved $70 million in synergies while their guidance was for $50 million. We believe the $120 million target for cost synergies for Atkins is somewhat sandbagged. SNC will probably surpass its guidance once more.

We see the potential for multiples to expand as SNC becomes a global company. Large cap engineering companies are trading between 10.7x and 15.7x 2018 EPS. With the deal closed, SNC is trading at 9x 2018 EPS. As such, SNC can easily trade above $65 as it catches up to its peers.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.37	0.02%
Palos Equity Income Fund - RRSP	PAL 101	$6.20	0.27%
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	$9.75	-2.51%
S&P TSX Composite			0.10%
S&P 500			8.80%
S&P TSX Venture			82.72%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			3.70%

Chart 2: Market Data*

	Value
US Government 10-Year	2.37%
Canadian Government 10-Year	1.83%
Crude Oil Spot	US $45.33
Gold Spot	US $1,224.70
US Gov't10-Year/Moody BAA Corp. Spread	209 bps
USD/CAD Exchange Rate Spot	US $0.7705

* Period ending Jul 6, 2017

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■ What is New on the Macro Level?

By Hubert Marleau

More on Productivity: An Underappreciated Assets

Many left-wing oriented economic thinkers believe that other factors are more important than productivity gains like welfare, health and educational services. They seem to think that the cost of productivity growth is too expensive. It's ridiculous. Productivity growth is desirable for it is the primary driver of GDP growth and income gains, without it, human needs and desires cannot be fulfilled and advances in societal objectives cannot be met. The resources that an economy possesses are scarce and how efficiently they are allocated will determine the pace of productivity. Productivity produces economic surpluses that can fund national security, well-being and equitable distribution of income. In this connection, it is important for governments to deploy resources in the direction of productivity. Consequently, savings should be incentivized to finance research projects, infrastructure, basic science, energy efficiency, engineering and innovation. In our judgement, there is a growing awareness among average citizens that productivity is the way to the future.

On Monetary Policy: Major Central Banks Intend to Follow the Lead of the Fed

The Palos Monetary Policy index, the inflationary composition of the Misery index, cyclical spending to GDP and indicators of financial and banking stresses, do not strongly suggest that the major central banks should quickly head toward normalization. Yet, based on recent remarks by the heads of western-based central banks, they appear ready and willing to tighten their monetary stance and end the ultra-loose global monetary policy causing a serious bond sell-off which is also affecting stocks. This is the exact opposite of what we have been hearing from them for years. Moreover, talk of a tighter monetary policy in the rest of world has weakened the U.S. dollar and has brought about a mini temper tantrum because it feels too coordinated. For central banks to hint that they might raise rates, inferring that they sense a looming inflationary inflection point is nonsense. Unless, they know something that we don't. I'm convinced that central bankers are more model-dependent than data-dependent as that would be the only argument that supports their insistence on changing the course of money.

Instead, inflation is running cold. The path to higher inflation has been bumpy and the economies of the western world are running at a stalled speed of 2.0% or less. The U.S. PCE deflator fell twice in the last three months and it's up only 1.4% year over year. Other than in Britain, consumer prices are not expected to top the 2.0% target in any of the major western countries. Inflation has been low for so long that many are thinking that the situation is structural and they have just become used to it. Low expectations feed into actual prices. The market expects the inflation rate will set around 1.5% for the next five to ten years. Many economists are just too old school using rational but defunct heuristics, like the "Phillips Curve", to see a problem where none exists. In our judgement, the best way to capture the outlook for core inflation is to use the combination of the rate change in productivity and prices. This combination determines what ought to be the increase in average hourly earnings. In this connection, the US is right on target for inflation is growing at the annual rate of 1.4% and productivity gains are about 0.6% per year. There is the 2.0% that the Fed and other central bankers want. Massive quantitative easing combined with zero bound interest rates does not produce inflation unless productivity rises. It's counterintuitive for a monetarist, but demography, globalization and technology have changed the economic environment and the financial context is failing old strategies. Accordingly, the Fed and other major central banks may not be as accommodating as they appear. The market is persistent in its belief that inflation will not rise any higher than 1.5% over the next decade or the policy rates may be near the neutral rate.

So, where is the beef? It can only come from concerns over financial instability, speculative excess or recession fears. Results from various financial stress tests and reports on recession risks are too low to create warranted fears. Moreover, I don't think that the presumed Vancouver housing bubble is big or wide enough to bring about a worldwide financial panic. It's too local.

The Central Banks, particularly the Fed, are more likely to normalize their balance sheets as letting maturing bonds roll off would tend to decrease bond prices and steepen the yield curve, which would equate to a series of rate hikes without actually initiating them. While a few rate hikes are acceptable, it remains that their balance sheet needs to be better controlled if they want to create some ammunition for the future. The FOMC minutes reveal that the Fed has a plan to reduce

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the size of its balance sheet and it could start the unwinding process within months. To get an idea of the magnitude of quantitative tightening, one only has to look at the size of assets that the major central banks have. Global central bank balance sheets add up to $18.4 trillion. In other words, the amount is equivalent to the size of the U.S. GDP. The monetary authorities have publicly admitted that the large asset position of the Fed has reduced ten-year treasury terms premiums by an estimated 80 basis points. That would put long-term interest rates around 3.00%. Coincidently, the "Palos Interest Rate Model" puts long-term U.S. government bond yields also around 3.00%. It will take about a decade to get rid of the bonds that are held by central banks.

On the Bank of Canada

As far as Canada is concerned, we probably got it wrong. The Bank of Canada did not apply any quantitative easing and, in turn, did not bloat its balance sheet during the financial crisis or afterwards. The Bank of Canada holds less than 15% of the total amount of government bonds outstanding. We may have been wrong on this one. If the rest of the world is indeed returning, albeit slowly, to more normalized policies, Poloz may want to take advantage of this perception and hike the policy rate a notch higher, arguing that he trusts the old economic rules that portend inflationary troubles ahead and that the economic cycle has not yet been discredited. While we do not disagree with this kind of thinking, old macroeconomic models ignore that time series often have behavior characteristics that can be completely different under certain contexts and periods. In this regard, two rate hikes of 25 bps may be in the bag in 2017, with one of them on July 12. Two rate hikes would bring back the Canadian policy rate to where it stood before the oil crash.

On a New Book: "Adaptive Markets" by Andrew Lo

This is the best book on finance that I have read in the last ten years. I read the book twice and decided to review it a second time. I did not want to miss anything. The book is just too important to ignore.

Andrew Lo teaches behavioral and evolutionary finance at M.I.T. The book manages to convincingly demonstrate that the efficient markets hypothesis, in strict form, is wrong. Firstly, neuroscience shows that the human mind is incapable of rational thought, presupposed by efficient markets. Secondly, behavioral psychologists show that many irrational biases exist in economic decision-making. Borrowing ideas from Darwin biology and theories from modern evolutionary biology, he developed the hypothesis that markets develop and adapt over time to new regimes, contexts and environments.

The ability to construct narratives is what intelligence is about, meaning that humans are not so much rational beings as rationalizing beings. We think in terms of stories. In this connection, humans are susceptible to judge risk incorrectly. Behavioral science and neuroscience attribute this latter observation to our rooted necessity to survive. In other words, fear is an early warning system that makes humans irrationally averse to loss. Put simply, we have a greater chance to avoid a loss than to make profit. What is most impressive about the book is that he blends rationality with emotional behavior and provides the basis of a new hypothesis on how the world of finance works. In reality, what Lo promotes is not entirely new, but he happens to be the first that I know of to quantitatively, empirically and theoretically advance financial economics into an adaptive market hypothesis. The bottom line is that he explains a full range of mysterious financial phenomena using Darwin forces of competition and adaptation that can give insight to investors, speculators and traders on how to better manage risks. This is a book that should be read and studied by money managers that take their jobs seriously.

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