PALOS
INVESTMENT FUNDS

August 10, 2017

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■Portfolio Management & Advisors

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Veuillez noter que le commentaire hebdomadaire de Charles Marleau ne sera pas publié cette semaine en raison de ses déplacements en visite d'une entreprise qui compose nos fonds Palos. Charles résumera sa chronique dès la semaine prochaine.

Please note that Charles Marleau will not be publishing his weekly commentary as he is currently visiting the facilities of a company held in the Palos funds. He will be back to write his commentary next week.

■ What is New on the Macro Level?

By Hubert Marleau

On the Canadian Dollar

The exchange value of the Canadian dollar increased in a fast and furious manner in the last few months vis-a-vis the U.S dollar. Since May 4, 2017, the Canadian dollar rose from 72 to 80 US cents a few days ago. That is two cents above our calculated purchasing power parity rate but two cents below its twenty-year average of 82 US cents. At the time of this writing, the loonie was fetching 79 US cents compared to only 68 US cents in January 2016. It appears that the Bank of Canada encouraged the recovery for it sold more than $1.0 billion worth of U.S. dollars in the last six months. Nevertheless, future performance will depend on what will happen to Canadian terms of trade, monetary policy and economic growth.

Since the early days of 2017, many important changes occurred favoring Canada vis-a vis the U.S. Firstly, Canadian terms of trade stopped

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.26	-1.12%
Palos Equity Income Fund - RRSP	PAL 101	$6.14	-0.70%
Palos Merchant Fund L.P. (Jun 30, 2017)	PAL 500	$4.22	5.65%
Palos IOU High Yield Fund (May 31, 2017)	PAL 701	US $7.00	-3.83%
Palos WP Growth Fund - RRSP	PAL200	$9.70	-3.03%
S&P TSX Composite			0.21%
S&P 500			10.25%
S&P TSX Venture			49.16%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			4.31%

Chart 2: Market Data*

	Value
US Government 10-Year	2.20%
Canadian Government 10-Year	1.85%
Crude Oil Spot	US $48.47
Gold Spot	US $1,285.50
US Gov't10-Year/Moody BAA Corp. Spread	208 bps
USD/CAD Exchange Rate Spot	US $0.7847

* Period ending Aug 10, 2017

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deteriorating when oil prices rose from the depths of 2016, stabilizing around $45 to $50 a barrel. In July, the Bank of Canada suggested that the adjustment to lower oil prices was largely completed. Secondly, economic activity surprisingly surged and even surpassed that of comparable developed countries. Gross domestic product grew at an annualized rate of 3.7% in the first quarter of 2017 and should expand another 3.0% in the June quarter. Thirdly, the fear of facing disruptive negotiations over NAFTA has moderated as Trump said on numerous occasions that he had no major problems with Canadians when it came to trade relations. Lastly, the Bank of Canada decided to alter its monetary stance when it hiked its target rate to 0.75% on July 12, thus inferring that the Canadian monetary authorities were willing to closely imitate the monetary stance and policy rates of the Fed. The action brought about higher real rates, luring foreigners to move and residents to keep new monies in Canada.

It should be noted that it is uncommon for the Canadian dollar to be on a tear. An abrupt upward move is usually connected with the behavior of currency traders and speculators. Hedge funds took large bets on the view that further appreciation was likely. They believe that another rate hike is looming, higher oil prices are heading higher and superior economic growth will continue. The U.S. Commodity Futures Trading Commission shows that there are a lot more long Canadian contracts than short ones.

We believe that we got the best out of the Canadian dollar. There are numerous red flags that are very threatening but completely ignored by speculators. Such as:

- Investors should acknowledge that the Canadian inflation rate is much lower than that of the U.S.
- The building blocks, like the commodity boom and housing bubble, upon which recent economic growth has depended on, have been severely impaired.
- The Bank of Canada might drag its feet and stay behind the Fed's course to avoid a policy mistake. The rotation toward business investments and exports, that the Bank of Canada had hoped for, has not yet materialized. Given the current low in business sentiment, this hope may vanish. Accordingly, we do not share the speculative view that Poloz will want to tighten financial conditions ahead of the Fed. He is more likely to follow the Fed with a delay.
- Interestingly, the Canadian trade balance has not improved for imports have increased as much as exports. Since the beginning of the year, Canada has only printed trade balance deficits.
- Net foreign capital inflows into Canada, in the form of security transactions, have totaled an estimated $55.0 billion in the three months ended June. Unfortunately, these inflows were largely offset by foreigners selling their oil sands investments. Outbound M&A totaled $60 billion during the first half of the year. Investment bankers have indicated that outbound M&A activity has not stalled. Pension funds have an enormous amount of liquidity with limited opportunities in Canada. Additionally, an increasing amount of the larger Canadian companies are manifesting a desire to diversify abroad and become global players.
- Canadian terms of trade are expected to rise slightly because we think that oil should trade up near its the marginal cost of production, which is near $55 a barrel. Oil inventories are down and likely to go lower. The contango curve has flattened considerably over the past month suggesting that prices may be on a more solid footing. Moreover, other commodities, like copper, are doing well.
- The Canadian economy has substantial leverage which makes it very sensitive to interest rate changes. While the current economic expansion is respectable, it remains that it is vulnerable to a downturn because of its overreliance on the housing sector and the failure of the average Canadian to reduce their debt load. Firstly, as much as 7.1% of Canadian workers depend on the housing construction industry compared to 3.8% in the U.S. Secondly, household debt to income is 150% in Canada compared to 100% in the U.S. Despite the low borrowing cost of capital, the debt-service ratio has been terribly sticky. For example, the average Canadian uses 14.5% of their personal disposable income to service debt. It's only 9.5% in the U.S. What is troubling is that average hourly wages are rising slowly at an annualized rate of 1.5% and, in turn, the wage situation is intensifying the problem. If one was to take away the "wealth effect" of the unfathomable rise in housing prices, the economic growth path could turn down.

Put simply, it seems that speculators and traders ran with the momentum, for it does not appear as though the recent dollar appreciation is related to the growing demand for goods, services and

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investments. In this connection, I would advise investors to be careful and resist the urge to unnecessarily augment their Canadian dollar position. The Canadian dollar is trading just about where it ought to be and investors should draw a line in the sand at 78 US cents. The estimated fair value is eroding and it may have to trade below its PPPR of 78 US cents for an extended period to get the full benefit from the export and trade sector. Aware of the fragility of the rise in the Canadian dollar, a high concentration of Palos' investments is in Canadian companies that sell a lot of their products in the U.S. and/or have a large asset exposure abroad.

On U.S. Productivity

The Bureau of Labor Statistic reported on Wednesday that nonfarm productivity rose at an annualized rate of 0.9% in the June quarter and was up 1.2% year over year. While worker productivity rose modestly, the trend remains sluggish. The poor performance is holding back economic growth. There are signs that the future trajectory may slowly improve for regulation is easing, intellectual property investment is growing fast and businesses are increasingly adapting their business model to new technologies. Unless productivity growth accelerates, the potential capacity of the economy will be compromised by the aging population and declining population growth. In a previous weekly commentary, we estimated that the productivity trend was rising and growing at the annual rate of 1.2% with good chances that we may see a 2.0% annual growth factor in a year or two. It should be noted that it is imperative to introduce proper tax policies and benefit efforts to advance basic research, construct infrastructures, educate children in the use of STEM[1], adopt new technology and encourage new enterprises that promote productivity. Otherwise, it will be impossible for society to succeed and to move forward at the right cost and in the right way. History is clear on this one, standards of living do not get better in a sustainable and even manner without productivity gains.

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

[1] STEM stands for Science, Technology, Engineering and Mathematics