Issue 37

PALOS
INVESTMENT FUNDS

September 14, 2017

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

StorageVault's (TSX: SVI) main business is owning, operating and leasing self storage facilities. Since SVI is the only public storage company in Canada, it is the only way for investors to get exposure to this space. We are attracted to this type of real-estate as it is the only one that can achieve 12% growth in net operating income (NOI). At the same time, SVI is consolidating the market by acquisition. Last quarter, SVI acquired a Montreal property for $8 million. Furthermore, on August 01, 2017, SVI announced the closing of the acquisition of Sentinel storage, which is made up of 24 properties, and is in the process of closing on 9 more properties. We believe SVI is well-positioned to acquire and integrate small and large operators. When I spoke to management, they seemed to have a robust operating/accounting system that could easily integrate acquisitions.

Many Canadians don't know that self storage real estate has been the top performing real estate class in the US for the past 20 years. Now that the Canadian self storage businesses are being consolidated, Canadians can finally invest in the space via SVI. We believe that NOI can continue to grow between 8%-10% for the next few years.

Lately, the stock has been trading lower and is now trading at a small premium to its Net Asset Value (NAV) compared to its historical premium. Since we are expecting strong financial results in the coming quarters, we have been taking advantage of the sell-off by adding to our existing position. There is no other real-estate company that can generate that kind of growth, which makes it less sensitive to rate increases.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.67	3.24%
Palos Equity Income Fund - RRSP	PAL 101	$6.34	2.60%
Palos Merchant Fund L.P. (Jun 30, 2017)	PAL 500	$4.22	5.65%
Palos WP Growth Fund - RRSP	PAL200	$9.89	-1.06%
S&P TSX Composite			1.22%
S&P 500			13.10%
S&P TSX Venture			52.67%

Chart 2: Market Data*

	Value
US Government 10-Year	2.18%
Canadian Government 10-Year	2.06%
Crude Oil Spot	US $49.72
Gold Spot	US $1,329.60
US Gov't10-Year/Moody BAA Corp. Spread	214 bps
USD/CAD Exchange Rate Spot	US $0.8221

* Period ending Sep 14, 2017

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■ What is New on the Macro Level?

By Hubert Marleau

What Is Going on in the U.S. Stock Market?

Economic data in the US has been pretty good lately, with Q2 R-GDP revised up to an annual rate of 3.0% and Q3 tracking 3.0%. Given that the current rate of broadly defined inflation is 1.5 %, it is reasonable to tag the increase in the level of nominal economic activity between 4.0% and 4.5%. Accordingly, ten-year US treasury notes should yield no less than 2.40% and possibly as high as 3.25%. At the time of this writing, ten-year notes were yielding 2.15%. It's confounding because the market is not listening to economic history. Indeed, it is common sense to believe that the combination of current and prospective price movements and economic performance should drive interest rates up. Yet, one would be unaware of this connection from looking at the actual level of treasury yields. Another pertinent question is why credit spreads, stock valuations and commodity prices are so resilient. The S&P 500 is up 10% year to date. It's as if no one cares about the collection of negative factors like climate chaos, geopolitical issues and political dysfunctionality. Even a chorus of reputable investors like Ray Dalio of Bridgewater Associates, Lloyd Blankfein of Goldman Sachs, Howard Marks of Oaktree Capital Group, Jeffrey Gundlach of Doubleline Capital and Warren Buffett of Berkshire Hathaway are saying that asset prices are too high. When broad concerns are shared by legendary investors, it is hard to ignore them. Therefore, we decided, some time ago, to hedge our bets with 5.5% of assets in gold. It remains that we are in a prolonged secular bull market that may last for another 10 years for we are in an environment where investment returns outshine the cost of capital and/or the cost of money is less than the rate of inflation.

The Abnormality Is Caused by the Monetary World Order

Andrew Norelli, of J.P. Morgan, has come up with an interesting notion explaining this abnormality. "Notwithstanding all discussion of balance sheet reduction and tapering, the developed market central banks in aggregate are still very much in expansionary mode, with the G4 balance sheets still growing by more than $1.0 trillion per year on an annualized pace." The thing is that the central banks are hands down more powerful than just about everything. When you think about it, the total amount of world savings is either held in cash or financial assets. From here, it is a question of supply and demand. The central banks have bought large amounts of various non-cash financial assets, removing what would have been larger supplies of government and corporate bonds, stocks and commodities and, by nature, what would have been lesser amounts of cash. Put simply, we've been witnessing an abnormal increase in the supply of money and decrease in non-cash financial assets. In other words, securities are replaced in the financial system by an equivalent value of cash. The thesis can be quantified by watching the ratio of cash to financial assets on a worldwide basis for it reflects the relative abundance or scarcity of cash available to purchase non-cash financial assets. Consequently, the speed with which cash is injected and financial assets are removed should, according to this rationale, influence asset prices. Put even simpler, if the ratio is rising, asset prices go up and down if it is declining. Voila!

A quick look at the US situation may be helpful to understand. On August 30, 2017 ratio of MZM to the Monetary Base was 3.8x compared to 9.8x at the end of December 2017. The point is that for the period under review, the monetary base (bonds o/s with the Fed) increased 4.7x while the money supply (cash) increased 1.8x. What is interesting to note is that for the same period, stock prices were up 2.9x. That is the difference between the augmentation of the Fed's balance sheet and the money supply. Currently, the acceleration in the balance sheets of central banks has turned negative but the rate of growth remains positive. At this point, market participants and policymakers believe that it is the size of the balance sheet that is important to both the market and the economy. Let's use the Fed's balance sheet as a proxy. If the monetary base was to stay close to $4.0 trillion, it would remain accommodating enough to prevent a recession and, in turn, a bear correction in either the bond and stock markets. Since the end of December of 2016, the S&P 500 is up 10.0% just about the same as the percentage increase in the monetary base. Therefore, it follows that the U.S. dollar may have borne the brunt of the dysfunctionality of governments, the geopolitical issues and the political divide. The US dollar is creating a money illusion, complicating the understanding of the financial environment. The exchange value of the U.S. dollar, against a library of major currencies, is down 10.0% since the end of December 2016. In other words, from an international perspective, nothing really happened. The fact that stocks and the dollar have gone in entirely opposite directions since the start of the year suggests that

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something must have changed and one of the two is interpreting things differently.

How Fast and by How Much Will the Central Banks Withdraw Their Support and Sell Non-Cash Financial Assets?

Unless the pace of productivity and/or the velocity of money picks up, market pundits may be persuaded by the Fed's plan to reverse its program of QE, which involves letting go of its bond holdings and could tail off. Many market participants believe that the Fed is not ready to sour or buck growth. The two aforementioned concerns, along with low inflation, are making the Fed cautious about raising rates. The decommission of QE will end with a whimper.

What about the U.S. Dollar?

The truth of the matter is that the dollar can have a direct effect on international company earnings performance and on the relative value of equities. As a rule, a weak currency can be bullish for stocks and vice-versa. In this connection, the currency market can be very telling. Unfortunately, calling the direction of a currency is not simple. In our view, it does not look as though the greenback will experience a reversal of fortunes.

- Compared to the U.S., the world is cheap. The gap between forward P/E in the U.S. (18x earnings) and the rest of the world (14x earnings) is indeed wide.
- The OECD is pegging the Purchasing Power Parity Rate of the Euro at $1.33 or 15 US cents higher than where it is now.
- There is a change in growth expectations between the U.S. and the rest of the world. Stronger global growth should help drive the Greenback lower. U.S. economic data has started to consolidate, while most major central banks are signaling that the end of cheap money is coming.
- It's common knowledge that President Trump favors a weak dollar policy. With the opportunity to fill more than half of the board seats on the Federal Reserve Bank, he could alter the course of monetary policy in less than a year.

Consequently, money flows are favoring the international markets. There is a structural underweight in foreign assets which is forcing international investors to reallocate their capital to correct the imbalances. The trade against the dollar is probably overcrowded. The Daily Sentiment Index (DSI) for the dollar is now very low and, therefore, the dollar could violently bounce from its extreme bearish reading. Yet, the currency fundamentals for the greenback are still bearish. Moreover, there are other reasons why we think the prospects for stock returns are not as bleak as the media professes. The point here is to show that most hedge fund managers make poor macro forecasts. Bear comments have been made since 2010. Also, the successful legendary investors are the ones who buy distressed assets, that most prudent investors would not touch. While investors are skeptical and worried that the market may die of old age, they should, instead, be focused on actual data drivers. Firstly, there is a lack of euphoria. The cash position for mutual funds is 3.3%, in line with historical averages and far from an overabundance of confidence. Secondly, both sales and earnings growth will continue into 2018. Thirdly, many U.S. corporations do not view their shares as overvalued for they are still willing to repurchase them. Fourthly, household balance sheets are their strongest since the 80's. Household debt service as a percentage of disposable income is around 10%. Job openings are growing, wages are rising and confidence is high. Lastly, inflationary green shoots are showing up in the U.K., China, India and the U.S.