PALOS
INVESTMENT FUNDS

January 11, 2018

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■Portfolio Management & Advisors

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

What Worked and What did not Work in 2017

In 2017, the Palos Income Fund LP was up 12.53% whereas the S&P TSX composite was up 9.10%. The fund generated a positive alpha of 3.43%. It's important to note that the fund's performance did not come from taking more risk. The funds value at risk (VAR) was equivalent to that of the TSX during the year, in addition, the fund's beta was also lower than that of the TSX. On a risk reward basis, Palos is pleased with its performance for 2017. However, as managers, it's important to analyze what did and did not work during the year.

The fund's top six sectors are:

Materials: This sector contributed the most to our 2017 performance. Our exposure to the electric vehicle battery materials was a theme that worked very well. We believe that this theme will continue to do well in the coming years. However, we need to keep a close eye on how battery technology is changing and what materials will be needed. The top performing stock in this sector was Lundin Mining Corp (TSX: LUN).

Technology: This sector also significantly contributed to the 2017 performance. Our exposure to the self-driving technology, artificial intelligence (AI) and productivity software themes had a very positive impact for the fund. We believe that these themes will continue to do well in the coming years, as blockchain, drones and AI gets integrated into the economy. The top performing stock in this sector was Shopify Inc (TSX: SHOP).

Industrials: The fund did well in industrials solely due to stock picking. Our picks in the industrial sector were more uncommon. For example, the fund held People Corp (TSX: PEO), Savaria Corp (TSX: SIS), Waste Connections (TSX: WCN) and New Flyer Industries (TSX: NFI). In the index, the sector is dominated by railroad stocks which we were underweight in 2017.

Consumer Discretionary: The best performing stock in this sector was Dollarama Inc, which is also a large portion of the index. However, the

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$10.23	1.02%
Palos Equity Income Fund - RRSP	PAL 101	$6.76	1.11%
Palos Merchant Fund L.P. (Sep 29, 2017)	PAL 500	$4.21	5.36%
Palos WP Growth Fund - RRSP	PAL200	$10.85	1.45%
S&P TSX Composite			0.53%
S&P 500			3.58%
S&P TSX Venture			4.56%

Chart 2: Market Data*

	Value
US Government 10-Year	2.53%
Canadian Government 10-Year	2.17%
Crude Oil Spot	US $63.56
Gold Spot	US $1,322.60
US Gov't10-Year/Moody BAA Corp. Spread	172 bps
USD/CAD Exchange Rate Spot	US $0.7979

* Period ending Jan 11, 2018

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other names that the fund held under consumer discretionary were different than the TSX core holdings. Spin Master Corp (TSX: TOY) and Enercare Inc (TSX: ECI) were two other names that we held in this sector. Please note that the consumer discretionary sector is dominated by auto parts and restaurants.

Financials: This sector did well for the fund and the index. We chose to overweight Eastern Canada and capital Markets via National Bank (TSX: NA). This strategy helped the fund perform well in the financial sector.

Consumer Staples: Similarly to industrials, our performance in this sector was mostly attributed to stock picking. Our top performing names were Jamieson Wellness (TSX: JWEL), Maple Leaf Foods (TSX: MFI), Liquor Stores (TSX: LIQ) and Alimentation Couche Tard (TSX: ATD/B). This sector is dominated by grocers.

Energy: This was the fund's only negative sector in 2017 and it represents a large component of the Canadian Market. This sector makes up 20% of the TSX. Unfortunately, the fund's performance in this sector was worse than that of the TSX. The fund had no exposure to the majors like Suncor Energy (TSX: SU) and Canadian Natural Resources (TSX: CNQ), which significantly outperformed the sector. Their vertical integration, accretive acquisitions and access to brent prices, made them a better choice. We were attracted to E&Ps that seemed inexpensive and had strong balance sheets. The problem was that they only got cheaper. Palos got caught in a perfect value trap while multiples were trading at historical lows. We believe that there will be a reset in energy stocks and continue to prefer oil over gas. We are investing in the companies that have strong balance sheets. With oil prices above $60US, these companies will be generating significant cash flows. 2018 could be the year where the energy bounces back.

Palos will continue to seek new investment opportunities. We believe that we are going through four significant revolutions: blockchain, electric vehicle batteries, legalization of marijuana and artificial intelligence/drones. We will continue to seek investment opportunities that will directly and indirectly take advantage of these revolutions. Secondly, Palos will also continue monitor some macro themes such as NAFTA, interest rates and the Canadian dollar. We believe that 2018 will be an exciting year with many opportunities.

■ What is New on the Macro Level?

By Hubert Marleau

On the Canadian Dollar

The Canadian dollar traded as high as 80.5 US cents a few days ago which is two points above our estimated Purchasing Power Parity Rate. We've raised the rate by half a cent because inflation has been less pronounced in Canada than in the U.S. over past the year. For example, the Canadian core CPI index advanced 1.3% in the last twelve months compared to 1.7% for the U.S for a difference of 40 bps. There are three principal reasons that help explain the robust performance of the Loonie. These are the expected convergence in the Canadian monetary stance with that of Fed, the general belief that commodities in energy, agriculture, industrials and precious metals have set lows in January 2016 and are on the verge of breaking out and that the economy may fair better than anticipated because consumer spending may hold up.

Firstly, until recently, it was the opinion of most Canadian observers that the Bank of Canada was likely to delay rate hikes believing that the Canadian economy was in a soft patch. A month or two ago, it looked as if economic growth was moderating. Canada's economy stalled in October on a decline in oil output. Statistics Canada reported in early December that GDP was unchanged in October from September suggesting that the final quarter of 2017 may be disappointing. Now, the outlook is very different. The unemployment rate declined to a historical low of 5.7% in December as new jobs totaled an impressive 79K. For the year, the number of jobs created by the economy was remarkable totaling 423k. This represents a year over year increase of 2.3%. Spectacularly, the bulk of the increase was in full time employment and as much as 25% of the increase was in high paid occupations. The Palos Monetary Policy Index, which takes into accounts the four macroeconomic objectives of Central Banking (Price Stability, Viable Balance of Payment, Full Employment and Economic Growth), presently stands at 147 compared to 148 for the U.S. History shows that when this index is above 100 and rising, central banks usually reduce their monetary accommodation. Moreover, the inflationary content of the Canadian Misery Index (the addition of the inflation and unemployment rates) is 27% - a level that monetary authorities cannot afford to let increase. The behavior of bond markets supports our thesis. Interest rate spreads between the U.S. and Canada have considerably narrowed in favour of the U.S. over the past few

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months suggesting that the monetary stance of the Bank of Canada will follow that of the Fed.

Secondly, it is widely known that the Loonie is classified by foreign exchange traders as a commodity currency. Rising commodity prices lead to improvements in Canadian terms of trade. Terms of trade improve when export prices rise faster than import prices which tends to help the trade account balance. While higher exports prices do not directly increase the level of real economic activity, they bring in extra money inflows that can indirectly have favourable consequences on consumer spending, government revenues and investments. Given that Canada is a very large exporter nation of natural resources, strong commodity prices are particularly important to Canada's economic well-being. The Bloomberg Commodity index, which tracks more than 20 essential commodities, has traded sideways since May of last year forming what speculators call a base. A consolidation zone often serves as a launching pad for a bull run. What may be of interest is that there seems to be an apparent coincident bottom about two years ago in gold, copper and oil. The argument is that the alignment represents a true bottom and a clear technical signal to look forward to as the growth of world economies seems to synchronize. Incidentally, the IMF has raised the prospect for world growth and global high frequency models are showing good numbers. Nevertheless, we are surprised that the November trade account did reflect the improved export prices. The fact is that Canadians may not have the infrastructure capability to take advantage of Canada's preferred pricing position. Canada needs more pipelines, more ports, more roads, more tracks and more free trade arrangements if it's going to profit from its natural resource endowment. For example, refineries in Eastern Canada import crude from overseas because it is easier to ship barrels of oil by tanker than move them on congested pipelines and railways from the western Canadian oil fields. The November trade numbers support the above suggestions. Statistics Canada reported that Canada registered an international trade deficit of $2.5 billion showing that exports of other commodities did not keep up with rising prices and demand. If the terms of trade do not show better trade numbers in December, it would confirm the problem. The reason why we wait for some confirmation is that the shutdown of the keystone pipeline following a leak in South Dakota certainly decreased crude exports. Nevertheless, as an export nation, Canadians cannot afford a structural export problem. Trade deficits usually mean that the demand for goods and services is larger than national output and, in turn, have a dragging effect on growth and on the value of a currency. At times, it forces monetary policy to be tighter than it should to be and forces the value of a currency above natural real worth.

Thirdly, strong increases in employment combined with rising average hourly wages and higher minimum wages in Ontario should keep consumer spending strong enough to maintain the current economic pace in 2018. The resilience is on the consumer side. In fact, forecast growth in the fourth quarter, according to Moody's high frequency model, should pick up to an annualized 2.4% pace, from the 1.7% pace in the third quarter, and expand by a similar amount in 2018. This increase is above what the Bank of Canada considers to be non-inflationary growth. The output gap, the difference between potential and actual growth, is disappearing. The Bank of Canada's quarterly survey of business sentiment shows that businesses are under the tightest capacity pressures since before the Great Recession. Fifty-six percent of the participants said that they have some difficulty or significant difficulty to meet unanticipated increases in demand. It's not surprising that average hourly earnings are edging up. Earnings are 2.7% higher than they were one year ago, and inflation accelerated to 2.1% in November from 1.4% in October.

The Bottom Line

Based on current hiring trends, prospects for capital expenditures and outlook for both cost-push and demand-pull inflation, it will hard for the Bank of Canada not to raise interest rates on January 17. Failure to do so, combined with all the major banks predicting a rate hike and businesses running out of capacity, could reverse the Canadian dollar's bull run and return its exchange value back to its true value of 78.5 cents US. Given the fear of possible hiccups or a breakdown in the NAFTA talks as well as the attraction of Poloz to drive exports, the Bank of Canada may indeed stay on the sidelines and not proceed with a rate hike. Theory and empirical evidence dictate that when monetary policy is not what it should be, the brunt of the deficiency falls on the currency market. The few days that the Loonie has been sliding suggest that the market believes that the Bank of Canada will not raise interest rates even though economic conditions says that it should. On Thursday, the exchange value of the Canadian dollar was trading for 79.83 cents US. If the market interpretation is correct, and we think

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that it is, the Loonie is heading back to where it belongs at $0.785.

As an aside, we may be making too much of the NAFTA situation. Dennis Gartman, an astute observer of the effects of political and economic events on the markets, does not think that Trump will make the mistake of canning NAFTA. He bases his opinion on the fact Trump has not talked or tweeted much about NAFTA in the past month suggesting that he may have changed his mind. It would not be the first time. Talks between Canada, Mexico and the U.S. will likely continue with the intention of revising NAFTA rather than abolishing it. Surely, the administration knows that the consequences of refutation on the economic, political and geopolitical fronts would be intolerable for all parties. Next week's commentary will discuss the yield curve and what is happening with copper prices.

Further Notes

Copper is having a sluggish start in 2018 despite encouraging economic data in the U.S. and overseas. Maybe one should not be too bearish as the volume of trading has been low and speculators might be just positioning for the new year. Copper prices are off their highs and gold prices have been doing rather well. Consequently, the price ratio of gold to copper has risen suggesting that since the start of the new year there have been bigger bets on inflation than on growth. Therefore, it does not make much sense for ten-year treasury yields to settle for only 2.50%. According to our interest rate model, treasury yields should trade at a 2.75% basis. Expanding budget deficits combined with lesser foreign demand and the Fed's decision to unwind its bond portfolio should bring about a mismatch between supply and demand. In fact, Goldman Sachs and Bank of America believe that the 10-year treasury yield will reach 3.00% in 2018. Interestingly, a measure of the bond market's expectations for inflation crossed a key threshold in the past week. The 10-year inflation break-even rate topped 2.0%. The new break-even rate matches the Fed's annual target for inflation. This rate probably relates to the Congressional decision to cut the corporate tax rate. Traders are bracing for higher inflation. Rising inflationary expectation is not confined to the bond market. Commodities like oil, copper and aluminum, key industrial materials that serve as bellwethers for the direction of consumer prices, are rallying and pronouncing the bullish outlook for world economic growth. It should be noted that the NY Fed's underlying inflation gauges (UIG) shows that annual increases in inflation are heading towards 2.25% and could end up as high as 2.75%. This morning the December producer price index came down a notch, but it is still 2.7% higher than last year. Additionally, the Atlanta Fed reported that one year and ten-year January Business Inflation expectations were 2.0% and 2.8% respectively. In this inflationary light, some exposure to gold stocks may end up in being a positive. Palos has accumulated gold exposure with them over the past six months believing that the US tax cuts could inflate the budget and trade deficits which have historically been bearish for the US dollar. It may turn out to be a good protection against inflation for all-in production costs for large producers are expected to fall to $850 an ounce in the next 12 to 24 months. The current price for an ounce of gold is $1320. Those are healthy margins.

Wall Street expects a banner fourth quarter for corporate earnings. Earnings season started this week and FactSet has predicted that S&P 500 companies will report that profits increased 11% year over year. It would be the third quarter out of four in which profit have risen by at least as 10%. The pick-up in world economic activity combined with a weak dollar and a lack of cost pressures gave an extra lift to profits. Post tax cuts, 2018 forward EPS for the S&P 500 should total $155 providing a yield of 5.60%. That's 310 bps more than the yield on ten-year treasury (2.50%). This makes the PEG ratio quite attractive at 1.8x. The PEG ratio is the P/E ratio divided by earning growth. The historical average is 3x.

Ernst & Young, a reputable consultancy firm, declared a few days ago in a public briefing that Canada needs a comprehensive tax review if it wants to keep its historical tax advantage with the U.S. and remain competitive. The average combined federal/state corporate rate in the U.S. have fallen from 39% to 26% and are now below the average combined federal/provincial rate of 26.7% in Canada.

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