PALOS INVESTMENT FUNDS

January 18, 2018

To subscribe to our Newsletters
www.palos.ca/register

■Portfolio Management & Advisors

Charles Marleau, CIM
President & Senior Portfolio Manager

Hubert Marleau
Economist & Co-Founder

Robert Boisjoli, FCPA, FCA
Chair of the Board

Wakeham Pilot
Director – Wealth Management

Bechara Haddad
Portfolio Manager

Joany Pagé
Financial Analyst

Evan Weiser
Junior Analyst

■Contacts

Palos Management Inc.
1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada
T. +1 (514) 397-0188 F. +1 (514) 397-0199
www.palos.ca

Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

The New Kid on the Block

In late 2017, Scotia Capital launched an Initial Public Offering (IPO) for Neo Performance Materials Inc. (TSX: NEO). The deal was done at $18.00 and the stock started trading on December 8, 2017. It was not well received and traded below its issue price on opening day. Palos has a different view on NEO. The Funds participated in the deal and we strategically kept some powder dry to buy more shares in the open market if the issue dipped below issue price.

Palos believes that the market is just not interested in traditional IPOs. This creates opportunities to invest in new IPOs that are being overlooked by the market. NEO is a prime example. NEO is a global leader involved in the innovation, development, processing and manufacturing of rare earth metals. The company produces some of the highest quality rare earth functional materials. They have 70-75% market share in bonded and hot deformed magnetic powders, they are a leader in auto emission-control catalysts, and are the number one producer of gallium trichloride for light-emitting diodes (LEDs). These products have a variety of uses from light weight micro motors, air and water emission control catalysts, electronics, medical equipment, aerospace components and in clean energy applications. These segments are all growing, especially with the electrification of automobiles.

NEO is also financially attractive. Here are a few highlights from their prospectus:

1. From 2014 until now, NEO's volume has increased at a CAGR of 8.6% and its adjusted EBITDA margin has increased by 387 bps.

2. For the twelve-month period ended June 30, 2017, Neo had $404.0 million in revenue and $63.3 million in adjusted EBITDA.

3. Despite the decline in prices in 2015 and 2016, Neo was able to grow its adjusted EBITDA margin.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$10.27	1.41%
Palos Equity Income Fund - RRSP	PAL 101	$6.79	1.55%
Palos Merchant Fund L.P. (Sep 29, 2017)	PAL 500	$4.21	5.36%
Palos WP Growth Fund - RRSP	PAL200	$10.90	1.85%
S&P TSX Composite			0.54%
S&P 500			4.73%
S&P TSX Venture			3.07%

Chart 2: Market Data*

	Value
US Government 10-Year	2.62%
Canadian Government 10-Year	2.23%
Crude Oil Spot	US $63.79
Gold Spot	US $1,327.10
US Gov't10-Year/Moody BAA Corp. Spread	164 bps
USD/CAD Exchange Rate Spot	US $0.8048

* Period ending Jan 18, 2018

PALOS INVESTMENT FUNDS

January 18, 2018

To subscribe to our Newsletters
www.palos.ca/register

■**Portfolio Management & Advisors**

Charles Marleau, CIM
President & Senior Portfolio Manager

Hubert Marleau
Economist & Co-Founder

Robert Boisjoli, FCPA, FCA
Chair of the Board

Wakeham Pilot
Director – Wealth Management

Bechara Haddad
Portfolio Manager

Joany Pagé
Financial Analyst

Evan Weiser
Junior Analyst

■**Contacts**

Palos Management Inc.
1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada
T. +1 (514) 397-0188 F. +1 (514) 397-0199
www.palos.ca

4. The company generates strong cash flows with low maintenance capex. This leads to a LTM Free cash flow conversion of 86.9% due to its focus on higher margin products.

5. The company has $78 million in cash and no debt outstanding with an undrawn credit facility of $15.4 million as of June 30, 2017.

Neo is a well established global leader in the rare earth metal industry. The company's attractive growth prospects, strong financials, long standing customer relationships, technical know-how, global reach, business strategy, and scale make it a very appealing contender in the space. This holding provides some much-needed exposure to a growing sector currently dominated by Chinese producers.

■ What is New on the Macro Level?

By Hubert Marleau

On U.S. Ten-year Government Bond Yields: Inflection Point or Trap?

The U.S. bond market is by far the most important financial market in the world. Just about every financial instrument is priced based on the ten-year treasury notes. This why it's crucial to watch 10-year Treasury yields for they can signal danger, caution or clear sailing ahead. Indeed, this bring us to the longest running and most important market trend, the 35-year fall in bond yields from 15.75% in 1981 to 1.36% in 2016.

Most investors neglect what is going on in the bond market, particularly stock market operators. This explains why many unseasoned investors like easy to understand and succinct stories. Stories create momentum, arguably an important force in any market. They are often influence by public narratives broadcasted by supposedly well-known experts. In this regard, two high profile fixed income investors announced that they have made or are about to make bearish bets on the bond market. Bill Gross, the so-call bond king of Janus Henderson, called "the end of the bond bull market" while Jeffrey Gundlach of DoubleLine Capital said that "the end is very near". The bearish statements are based on several factors. Firstly, the technical selling point of the long-term trend lines has been breached in both the five and ten-year Treasury maturities. Secondly, many believe that there is a mismatch between supply and demand for treasuries resulting from the Fed's unwinding of its bond portfolio. Foreign officials are planning to reduce purchases of long duration bonds as the U.S. government is stimulating the economy further with deficit-funded tax cuts. The notion that inflation will re-emerge resulting from full employment while global growth is robust and synchronized has also taken root. There is also the possibility that the Fed may consider a change in its inflation-targeting framework in favour of a price-level target and do away the 2.0% inflation target. A decision to implement a price-level target would tolerate higher inflation and, in turn, raise inflationary expectations as the pace of inflation has been consistently below 2.0% for years. Finally, the steady slide in the exchange value of the dollar to a 3-year low stems from an awareness that around the world central banks are moving toward ending ultra-loose monetary policies. There is an apparent wish on their part to add other currencies like the renminbi in their currency reserves.

In a nutshell, when an economy is running at full employment and is stimulated with deficit-funded tax cuts, the economy ends up in widening the deficits in both the trade and budget accounts. Twin deficits can be bearish for the bond and exchange markets. Overall, there are good reasons to think that the constellation of conditions that have been so good for years will not last. The conjecture that the 32-year bull market in bonds may have, indeed, ended in the middle of 2016 when ten-year yields on U.S. notes touched an historical low of 1.36% may indeed prove correct. That's more than 100 basis points from where they are today (2.55%).

In our judgement, the story seems too clean, too easy and too popular. We sense that something could go wrong. Firstly, economic growth could disappoint. The growth of total employment is decelerating. Therefore, if growth is to continue, gains in productivity will become necessary. At this point, it looks probable that productivity rose as much as 1.5% in the quarter ended December 2017. While productivity numbers will likely be good again in the first quarter of 2018, the experience with productivity has not been this positive for a very long time. Secondly, consumer spending could also disappoint. Personal disposable income is up only 1.0% and not keeping up with retail sales. Consequently, the personal savings rate is at the lowest point in ten years. It dropped to ten-year lows of 2.9% in November from 3.7% a year ago. Put simply, in order to maintain the current pace of spending, big increases in consumer credit and a reduction in savings will be needed. It may turn out to that

PALOS
INVESTMENT FUNDS

January 18, 2018

To subscribe to our Newsletters
www.palos.ca/register

■Portfolio Management & Advisors

Charles Marleau, CIM
President & Senior Portfolio Manager

Hubert Marleau
Economist & Co-Founder

Robert Boisjoli, FCPA, FCA
Chair of the Board

Wakeham Pilot
Director – Wealth Management

Bechara Haddad
Portfolio Manager

Joany Pagé
Financial Analyst

Evan Weiser
Junior Analyst

■Contacts

Palos Management Inc.
1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada
T. +1 (514) 397-0188 F. +1 (514) 397-0199
www.palos.ca

consumers may not be able to do so as the rise in interest rates and in energy prices takes an increasing charge on income. Thirdly, the process of normalization could take the flattening yield curve to inversion and cause a significant slowdown or even a contraction in the level of economic activity. Fourthly, the ratio of federal debt to N-GDP is 77%, a historical high. The cost of rising interest rates would create big losses in the system and create a dragging effect on spending and a reduction in economic growth. The Congressional Budget Office, a non-partisan organization, calculated that cost on the Federal debt would rise from $270bn to $712bn over the next decade if 10-year yields were to rise from 2.00% to 3.50%. That excludes the Trump tax cuts. Lastly, aging demographics are pushing a global saving glut into fixed income keeping inflationary forces at bay. Technology and globalization are proving to be a deflationary force across a broad range of global industries.

The bottom line is that the overall course of the economy is not likely to deviate much from what we have experienced in past few years. The exception will likely be that the slowdown in employment will be approximately offset by productivity gains. In nominal terms, Palos assumes that N-GDP will continue to expand at the annual rate of 4.0% for the foreseeable future. Unfortunately, the bond market is chaotic because it aggregates a multitude of decisions from a large variety of participants that have different objectives and outlooks. It needs to respond to complicated and ever changing economic environments. This complexity is why Palos use a simple rule that cuts through this complexity to determine what should the appropriate yield for ten-year treasury notes. Long term interest rates are a function of changes in N-GDP. History shows that ten-year bond yields are on average about 140 bps less than the annual change in N-GDP, or between 60% and 75% of the annual change in N-GDP. Our simple interest rate model predicts that ten-year bond yields should trade no lower than 2.40% and no higher than 3.00% to average 2.75% in 2018. Derivative contracts indicate that the pros believe that 10-year Treasury yields will be below the 3% mark in two, five and ten years' time. That is our base-case scenario. It spells caution, not disaster. In any case, Dow theory reminds us that the most important rule in technical analysis is "not to bet against a trend that is intact". There is also the thorny issue of the "term premium", the extra yield that investors demand for the risk of lending money for the long term. The NY Fed estimates that if one were to take bring the current negative term premium to zero, 10-year yield would be 30 to 50 bps higher than where they are now (2.55%). On balance, investors should stick with stocks but substitute bonds for cash, carry more cash than usual and watch the gold-to copper ratio, real rates, the yield curve and, most of all, the U.S market ten-year treasury. It's just too early to read the market's last rites. As commentators on CNBC have said "the bond market is not in a strong Colombian espresso bear market but in a mild decaffeinated bear market."

The Economics of Investment Work Better With Simple Rules:

Simple rules are strategies that save time and effort by focusing one's attention and simplifying the way information is processed.

Simple rules are highly effective because they do three things very well. Firstly, they confer the flexibility to pursue new opportunities while maintaining some consistency. Secondly, they can produce better decisions. When information is limited, and time is short, it makes it easier for investors to make sound choices. Thirdly, they allow investors to organize and synchronize their activities and ideas.

Effective rules share common traits. You can only have a handful of them. Capping the number of rules makes them easy to remember and maintains a focus on what counts the most. Rules are tailored to what the investors need. They apply to a well-defined activity or decision. They offer clear guidance while conferring the latitude to exercise discretion. Put simply, I use effective rules not as mechanistic tool to predict bond and stock market returns but as guidelines to make good judgements. In this respect, we balance concrete rules with freedom to exercise judgement.

What is particularly important is that effective rules provide a powerful weapon against the complexity that often overwhelm investors. Complexity arises whenever a system has multiple interdependent parts whose dependencies can change frequently and unpredictably like the economy and its markets. In October of 1948, Warren Weaver, a mathematician who work for the Rockefeller Foundation, published an 8-page article titled "Science and Complexity". In this article, Weaver describes science as progressing through 3 successive eras - simple, uncertain and complex.

PALOS
INVESTMENT FUNDS

January 18, 2018

To subscribe to our Newsletters
www.palos.ca/register

■Portfolio Management & Advisors

Charles Marleau, CIM
President & Senior Portfolio Manager

Hubert Marleau
Economist & Co-Founder

Robert Boisjoli, FCPA, FCA
Chair of the Board

Wakeham Pilot
Director – Wealth Management

Bechara Haddad
Portfolio Manager

Joany Pagé
Financial Analyst

Evan Weiser
Junior Analyst

■Contacts

Palos Management Inc.
1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada
T. +1 (514) 397-0188 F. +1 (514) 397-0199
www.palos.ca

1. Simple problems address a few variables that can be reduced to a deterministic formula such as MV=PT (money supply times velocity equals price times trade) or (N-GDP equals MV). In this case, rules are truisms and good at defining relationships between few variables. For example, the price of a good is the product of supply and demand. Price is the way desired demand and desired supply is turned into quantitative demand equals quantitative supply. Simple problems occupied scientists for most off the seventeenth to nineteenth centuries.
2. By the late nineteenth century, scientists shifted their attention to problems of uncertainty such as the motion of large numbers of objects or trying to pick which coloured die will come out of an urn. The quest to understand these problems led to probability theory, statistical analysis, and in turn information theory. For example, it is impossible to guess with any accuracy the daily price movements of stocks. Empirical evidence shows that in the fullness of time daily stock prices have upticks about 51% of the time and downticks for 49% of the time. It may sound unbelievable, but the 2% difference accounts for a large part of the rise in the S&P 500 since 1924.
3. In the middle of the twentieth century, the interest of scientists turned to the messy and unexpected way many components interact with each other. Complexity covers the untidy yet vibrant realm where much of economic life unfolds. Dealing with complexity is difficult. On a macroeconomic level, changes come about from unpredictable interactions of many moving variables. To make matters worse, the globalization of trade, capital and work, and the revolutionized interconnectedness of the internet have doubled the complexity of things. Despite all of the complexity that is involved in economics, history is pretty clear that interest rates are basically a function of the pace of economic growth plus inflation.

Many investors have tried to address complex and chaotic problems with intricate and hard to understand solutions. Consequently, many investors seek stories to get around this dead-end. We think storytelling and applying complicated solutions is flawed. To illustrate how quickly complexity can escalate out of control, consider an apparently simple question: How many ways can you combine six lego blocks? For one block the answer is trivial: 1. With massive computer power, it was recently discovered that there are 915 million possible combinations of 6 pieces of Lego. Complexity, as it pertains to theories of chaos and adaptive systems is a hot topic in scientific research. The existing research does not provide practical guidance on how to manage complexity. By the same token, how-to books that offer advice on how to simplify things by decluttering your closets are not any better. There is a growing body of empirical evidence that shows that simple rules can tame complexity better than the aforementioned methods. Simple rules that are effective are not fixed or immutable but evolve and adapt in light of new evidence. In other words, investors should have a repertoire of rules to cross check. Palos monitors daily a checklist of a few dozen specific rules highlighted in a form of a highly effective. Our rules are anchored on solid evidence and theoretical validity while maintaining flexibility. They have so far proven to be pretty good at making profitable trading calls, speculative bets and strategic investment decisions. Of course, our rules do not work perfectly, but when they are consistently carried out they have helped us to avoid big mistakes. Consistent execution of the basics is a good way to manage risk as it assures predictability, efficiency and few errors.

Sources:

Simple Rules by Donald Sull and Kathleen Eisenhard
The Adaptive Hypothesis by Andrew Lo
Investing by Robert Hagstrom
Principles by Ray Dalio
The Acquirer's Multiple by Tobias E. Carlisle
A Wealth of Common Sense by Ben Carlson
Algorithms to Live By by Brian Christian and Tom Griffiths
Speak like Churchill, Stand like Lincoln by James C. Humes

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