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■ **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

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

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Palos Weekly Commentary

■ **Palos Funds**

By Charles Marleau

Why we Love Canada!

Many economist and strategies on the sell side are bearish on Canada. Their reasoning mostly comes from the overvalued housing market, Canadian indebtedness, and the lack of Canadian energy infrastructure. Palos believes this argument has merits which have lead to negative sentiments on the TSX. These potential headwinds have the TSX is trading at a 2018 forward P/E of 15.16x and a 2019 forward P/E of 13.73x. This compares to S&P 500 that is trading at a 2018 P/E of 17.36x and a 2019 P/E of 15.74x. In our view, the negative sentiment has gone too far. Economists and strategists are ignoring Canada's favourable positioning on the four great revolutions. Moreover, most Canadian companies that are listed on the TSX have grown their operations in the US and around the globe. The four revolutions affecting Canadian companies are:

1. The Electrical Vehicle and Battery Revolution: Palos believes we are only at the beginning of hockey stick growth. Canada is very well positioned to become a leader in battery

materials such Nickel, Lithium, Graphite, Graphene, and Copper etc.

2. The Global Marijuana Legalization Revolution: Canada is at forefront of global legalization of Marijuana. This is not just a Canadian phenomenon, but a global one. Canada, is well position to become a global supplier, and innovator of medical marijuana.

3. The Drone / Artificial Intelligence Revolution: Transport Canada is moving very quickly to allow drone deliveries. It seems like Canada will be one of the first countries to allow logistics businesses to move goods beyond visual line-of sight via drones. This could lead to swarm technologies that will revolutionise the logistics business. This could have a significant impact on efficiency and the Canadian economy.

4. The Blockchain Revolution: Canada is well position to become a leader in cryptocurrency mining. With low energy costs and a cold climate, Canada is a premium destination for server farms. Secondly, it seems that our capital markets have welcomed blockchain technology with open arms.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	\$9.82	-3.07%
Palos Equity Income Fund - RRSP	PAL 101	\$6.48	-2.94%
Palos Merchant Fund L.P. (Dec 29, 2017)	PAL 500	\$4.61	15.26%
Palos WP Growth Fund - RRSP	PAL200	\$9.91	-7.06%
S&P TSX Composite			-4.66%
S&P 500			0.49%
S&P TSX Venture			-2.48%

Chart 2: Market Data*

	Value
US Government 10-Year	2.81%
Canadian Government 10-Year	2.18%
Crude Oil Spot	US \$60.99
Gold Spot	US \$1,317.90
US Gov't10-Year/Moody BAA Corp. Spread	169 bps
USD/CAD Exchange Rate Spot	US \$0.7790

* Period ending Mar 1, 2018

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We see Canada becoming a leader in blockchain and a quick adaptor of the technology.

The above revolutions all have one thing in common: they all need electricity. Canada has one of the world's lowest energy prices via renewable sources, and natural gas. This gives Canada a significant comparative advantage. These market forces should keep unemployment low and keep the Canadian economy humming. We don't see Canadian indebtedness being a serious problem for the Canadian economy.

■ What is New on the Macro Level?

By Hubert Marleau

Is 3% Real Growth Sustainable?

There are three ways to look at the economy.

Firstly, there is the monetary side that deals with the money supply. The money supply is a proxy for credit demand and its velocity which is a proxy of its use. We evaluate money supply with the Fisher equation where MV (money supply times its turnover) equals $N-GDP$. Currently, MZM is growing at the annual rate of 4.5% and velocity is basically registering flat growth. A maintenance of these two monetary trends suggest that if inflation was to remain on target at 2.0%, the real growth of economy would only be 2.5%. This is around where the Fed pins both growth and inflation for 2018. The Fed is of the monetary persuasion and insists that it can keep the inflation rate at 2%. To get that extra half- point in real growth, either credit demand must rise and/or a larger amount of the increase in credit needs to be directed towards real physical investment rather than financial ones. Current money flows are encouraging.

Secondly, there is the cyclical demand side of the economy which relates to the concept of full employment and price stability. Last week, I put forward our concern that we're not sure if the economy is at full employment or not. If it's not, a large portion of the population that could work would need to join the labour force and find jobs. The labour participation rate would have to rise considerably. In our judgement, it is almost impossible for employment to increase more than 1.0% in 2018 and beyond; if it did, inflation would likely become a major problem forcing the Fed to be more hawkish than expected by most bond market participants. Nominal interest rates would cross that of inflation and/or the yield curve would invert, and/or the Federal funds rate would rise above the neutral rate. Then, the nature of the

business cycle would not allow economic growth to advance forward to 3.0%. In the last four years, about half of the reported GDP growth resulted from cyclical forces. In fact, consumer spending has risen much faster than GDP. The surge in consumer expenditures caused a significant four-year-drop in the personal saving rate from 6.5% to 2.4%, the lowest amount on record. Consequently, there is not much more cyclical demand capacity to rely on for growth.

Thirdly, there is the underlying potential output of the economy often referred to as the supply side. The supply side is driven by growth in the workforce and productivity. Assuming current immigration and employment rates, it's hardly possible for the workforce to expand much beyond 0.75% a year in 2018 and over the next decade. That leaves us with productivity growth. In order to achieve 3.0% real growth, the economy would need to generate a 2.25% annual growth rate in productivity. Palos thinks that it is doable.

The Productivity Question

Nine years into recovery from the "Financial Crisis" labour-productivity-growth has, until very recently, been anemic. The downshift in productivity growth has been remarkable and caused political troubles like the populist movement, the yen for protectionism and discontentment with inequalities. For decades, labour productivity grew an average annual rate of 2.2%. In 2004, all hell broke loose. The rate of productivity growth cratered to an average of 1.2% up until 2014. Since 2011, the annual rate of change declined further to 0.5% with many negative quarters. Disappearing productivity is particularly important because the working force is aging, immigration is slowing, and a larger amount of the population wants to stay out of the labour force when growth is still a prime objective of governments. Under a lack of productivity growth, it's hardly possible to increase real wages improve living standards, reduce the debt overload, decrease inequalities and remain globally competitive.

There are many reasons for the descent in productivity. Some say it is just bad luck. Others blame it on the fallout from the financial crisis, the lack of active investments, deficiencies in price discovery, or the slow diffusion of technology. Moreover, there is the thesis that the benefit of innovation has resulted in less inflation rather than more production. Perhaps, things are about to change. The economy seems to be changing gear. Since the second quarter of 2017, an upswing in

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productivity growth has occurred. In the nine months ending March 2018, Palos estimates that productivity could be up by as much as 1.6% on an annualized basis. This is a notable change and maybe even a turning point. If this uptick lasts long enough it could lift America's growth potential. The corporate tax cuts, the repatriation of foreign cash balances, and one-year depreciation allowances are forces that are pushing business spending into capital formation like digitization, software, internet applications and artificial intelligence. In turn, these advancements are pressuring local utilities to install ultra-fast broadband infrastructure. It's interesting to note that the general population is directing their capital into passive investments rendering little service to the economy and reducing the financing of innovation. Fortunately, seasoned and well-informed investors are increasingly going the other way, investing more of their money in private ventures or in publicly trading companies that are in position to make major productivity differences. Our enthusiastic prediction for higher productivity is somewhat supported by a recent study published by the McKinsey Global Institute.

The McKinsey Report

Researchers at McKinsey have found that productivity advancements don't happen in a vacuum just because technology is available. They argue that the tide is poised to turn because the ingredients are in place for the next wave to be driven by digitization. The diffusion of new technologies into everyday use holds promise for bringing back the annual 2% plus productivity growth seen in the past. Looking back at the past half-century, they estimated that the time it takes for new technologies to obtain a 90% commercial availability ranges from eight to 25 years. Digitalization began about 10 years ago. We are still in the early stages of digitalization, but we are starting to see its growing effects on several industries. Put simply, digitization contains the promise of significant productivity-boosting opportunities and is about to overcome tough barriers such as long lags and expensive transition costs. So far, industries in the forefront of digitalization like technology, media and financial services are transferring their experience to agriculture, hospitality, health care, manufacturing government and education. For example, the retail sector, one of the laggards on digitization, has just started to disrupt the brick-and-mortar retailers. Only 9% of disposable income of consumers is spent online, but e-sales are growing at a rate of 15%. Another example is

the construction industry. Construction jobs have not changed much over the decades because the industry is a rock of solidity to which seven million unionized workers cling. One can look at how that industry functions. Often, the industry hires ten workers to do a job that two could manage just as safely and easily resulting in massive overruns. This has brought big problem in the form of low productivity and high costs. Thankfully, contracts and rules are changing under the pressure of new technologies and public works departments of municipalities. Perhaps it is time to tackle the thorny issue of overstaffing, of regulatory interruption, of eliminating long lags, of streamlining permitting, of harmonizing building codes and of inconsistent flows of construction.

The room for digitization is enormous. According to McKinsey, as economies returns to full employment, reliance on labour becomes difficult to count on. In such circumstances, outbursts of faster growth in productivity becomes a real possibility. While innovations are an absolute necessity, productivity growth depends not just on the supply side of the economy. What companies produce and what technologies they use to do so also significantly depends on the demand side. In other words, companies need to increase production to match the desired demand. Shortages of materials and workers force companies to think creatively. Since the financial crisis, there has been a lot of slack in the economy and, therefore, little need for corporations to spend a lot of money on capital expenditures. This is dramatically changing. Business capital formation is currently rising considerably faster than GDP. This shows that businesses need to beef up their capacity to produce more goods and services. The apparent increase in demand is pushing the newest technologies into older industries that want to keep up. For example, Coca Cola is orienting most of its investments into digitization as are many legacy companies. It's understandable that new technologies are firstly implemented in the latest factories. This dynamic is now increasingly being applied in to industries such as restaurants, retail, tourism and health care. The introduction of tax cuts and faster depreciation rates are making companies more open to install technology because they can now afford the upfront costs and the organization effort. McKinsey's thesis is simple. "The optimistic case for both productivity and overall economic growth goes like this: For the last several years, a lack of demand and plenty of spare capacity of both workers and equipment made businesses complacent and unwilling to invest in new equipment, software or new ways of

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doing things that might allow more output per hour of labor. Now, with companies having a harder time finding qualified workers and with demand for their products rising, they'll have no choice but to re-engineer how they work to increase productivity. Higher productivity will in turn make it easier to justify higher wages, creating a self-reinforcing cycle of higher economic growth.”

If, indeed, the U.S. is on the cusp of a shift to sustainable growth due to higher productivity rather than higher employment, interest rates may not need to increase as much as many strategists are forecasting. The probability is pretty good that the bulk of real growth will come from a 2.25% annual increase in productivity and the rest from a 0.75% increase in employment. That is not to say that the level of interest rates will not rise; if they do, it will be more as a consequence of higher real growth than higher inflation. The natural interest rate may be higher than our current 2.00% estimate suggesting that the Fed may continue to be accommodating even if the policy rate was to cross the perceived red line. A sustainable bounce in productivity back to past trends would lift the natural interest rate to perhaps as high as 2.50% for the federal funds rate and 3.50% for ten-year treasuries.

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