Issue 11

PALOS
INVESTMENT FUNDS

March 15, 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

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

How 'Bout Them Magnets

The market for rare earth elements (REEs) is set to grow significantly in the coming years. Many research reports are forecasting global demand for these elements to double by 2020. The growth wave is coming from clean energy applications such as wind power. However, the electric vehicle revolution is the largest emerging market for these products. Palos believes that this is a significant change that should not be ignored.

The REEs are primarily refined into two elements neodymium and praseodymium, also known as NdPr. The NdPr is then shipped in oxide form and used to make the lightweight neodymium-iron-boron also known as NdFeB. The NdFeB is the magic ingredient necessary to make permanent magnets inside high-efficiency motors and turbines. Many auto makers like Tesla are using permanent magnet motors because they are lighter, stronger and more efficient. For example, the Tesla Model 3 long range model, probably the most famous EV vehicle on the market, uses permanent magnet.

The Palos Funds are invested in REEs via Neo Performance Material (TSX:NEO). The performance of the stock has been surprisingly sluggish, especially since the company has been reporting strong financial numbers. NEO has a division called Magnequench which produces rare earth magnetic powders for bonded and hot deformed fully dense NdFeb magnets. These powders are an essential component in electric motors. The division reported a 44.8% revenue increase y/y and a 54% increase in EBITDA y/y.

The company now has US$100 million in net cash, which is approximately 20% of its market cap, and trades at 5.3x 2018 EBITDA well bellow its peers. Palos believes that NEO is well positioned, to take advantage of the electrification of the automobile. While the stock price might not yet be performing, Palos is happy to wait until the market starts to recognize the importance of REE to electrical vehicles. In addition, the fund gets a 2.36% dividend.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.98	-1.49%
Palos Equity Income Fund - RRSP	PAL 101	$6.57	-1.57%
Palos Merchant Fund L.P. (Dec 29, 2017)	PAL 500	$4.61	15.26%
Palos WP Growth Fund - RRSP	PAL200	$9.83	-7.77%
S&P TSX Composite			-2.78%
S&P 500			3.19%
S&P TSX Venture			-2.63%

Chart 2: Market Data*

	Value
US Government 10-Year	2.83%
Canadian Government 10-Year	2.14%
Crude Oil Spot	US $61.19
Gold Spot	US $1,316.60
US Gov't10-Year/Moody BAA Corp. Spread	179 bps
USD/CAD Exchange Rate Spot	US $0.7661

* Period ending Mar 15, 2018

PALOS INVESTMENT FUNDS

March 15, 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

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

■ What is New on the Macro Level?

By Hubert Marleau

On the Canadian Dollar

Palos has lifted the Purchasing Power Parity Rate (PPPR) of the Canadian Dollar to $0.7825. In the past twelve months core producer prices rose less in Canada (1.6 %) than in the U.S. (2.2 %) and core consumer prices increased less in Canada (1.2 %) than in the U.S. (1.8 %). At the time of this writing, the Loonie was trading blow it's PPPR and settling for $0.7622 in the foreign exchange market. There are four reasons why we think that the Loonie is trading below just value. Firstly, fear of trade protectionism and the possible collapse of NAFTA negotiations are weighing heavily on the Loonie. Secondly, the Canadian monetary stance is less hawkish than that of the U.S. at a time when the interest rates on maturities are less than they are in the U.S. Thirdly, Canadian terms of trade are unfavorable as heavy crude oil produced in Canada is crossing the border at huge discounts to prevailing market prices. Fourthly, concerns are widespread in Canada that investments could take a hit due to sudden deep cuts to U.S. corporate taxes and larger depreciation allowances making the U.S. a more attractive destination for investments earmarked to North America. Accordingly, the Loonie has given back all the increase value against the greenback it registered in 2017.

The Canadian dollar's poor performance of late has done little to shake strategists' conviction that the currency will outshine most of its peers by the end of the year. The Bloomberg aggregate forecast is that the Loonie will rise 4.8% between now and December reaching $80.50. The question is what market narrative speculators, investors and retailers need over the next while to compose an attractively viral proposition and build a bullish forecast.

When it comes to foreign exchange, one of the most fundamental factor that determines the relative value of a currency is the degree of dependence on foreign capital to finance saving deficits. Canada does well when it comes to attracting foreign capital. Countries with huge saving deficits combined with raging inflation problems usually do not do well in this regard. Canada has, for the most part, avoided this economic disease. In 2017, foreign investment in Canadian securities totaled $180 billion while Canadians invested only $80 billion in foreign securities. The net difference was more than sufficient to cover the saving deficiencies partially resulting from $18.1 billion budget deficit and the $15.0 billion trade deficit. In fact, there are some compelling reasons why it is relatively easier for Canada to fetch foreign capital than the U.S. One only has to look at interest rate differentials between Canada and the U.S. In spite of the fact that growth and inflation rates are similar including policy rates yield curves, Canadian interest rates from two years on are much lower than they are in the U.S.. For example, two-year (2.26%) and ten-year (2.90%) U.S. Treasury yields are respectively 50 and 65 bps higher than comparable Canadian bonds. The narrative surrounding this weird but bullish observation is related to little known facts.

The federal budget deficit in Canada is expected to total around $18.0 billion, including a $3.0 billion risk adjustment in 2019 representing 0.8% on the N-GDP compared to 5.5% for the U.S.

The Canadian current-account balance is about to 2.7% of N-GDP compared to 4.0% for the United States.

Government of Canada debt totals $675 billion or 33% of N-GDP while U.S. Federal debt totals $20.2 trillion or just about 100% of N-GDP.

A compelling story for a strong Canadian dollar could be made around these broad facts. Unfortunately, a few shorter-term factors would have to change. Firstly, the emphasis on uncertainties generated by the difficult NAFTA negotiations is blurring economic analysis making it difficult for business people and market participants to pin down intentions of businesses and market players. A quick resolution is needed so that a sense of confidence can emerge. Secondly, investors are expecting the Federal Reserve to hike interest rates faster and more aggressively than the Bank of Canada over the next twelve months. The trading in swaps are suggesting that the Bank of Canada will only hike rates twice while the Fed is definitely on to three increases and possibly four. There isn't much sense to this because inflation rates are about the same and both economies are near full employment. Interestingly, both Poloz and Powell, by their central banks own measures, believe that they are about two percentage points below what would be considered a neutral level for their respective policy rates. This could change down the road into the latter half of 2018. With a bit of luck, the aversion of risk on the part of Canadians could tilt to one of tolerance. Thirdly, history shows that there is a strong positive correlation between the value of the Loonie and

PALOS
INVESTMENT FUNDS

March 15, 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

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

oil prices. While this relationship can be interrupted from time to time by external forces, it is worth closely monitoring the price of oil as its effect on the Canadian terms of trade can be very large. Energy is a big factor in the overall economy and in the export market. Given the 25% discount that Canadian producers must give to Americans to buy our oil and gas, it is essential for the price of oil to be somewhat above its marginal cost to get some surplus benefit out of oil trading businesses. If the price of oil rises to $65 a barrel and stays there for a while, Canadian terms of trade would significantly improve. Palos expects the price of oil to rise in 2018 and beyond, but not above $70 a barrel. The IEA, a Paris-based organization that gives advice on energy trends, predicts that world demand for crude will increase by 1.5 million barrels a day to reach 99.3 million in 2018, an upward revision of 90,000 barrels. In the opinion of the EIA, the rebalancing of the market is moving ahead with supply and demand becoming more aligned.

It's a tall order. Yet, there is a good chance that the Loonie narrative could change for the better. Accordingly, the Loonie may be a good buy when it trades below its PPPR. A forecast compiled by Bloomberg predicted that the Canadian dollar will rise to 80.75 U.S. cents.by the end of the year.

One should ask if there is a risk of failure. What could go wrong? Put simply, housing and/or NAFTA and/or Poloz are all risks. We are optimistic that neither will turn for the worse. Nevertheless, we are concerned with some of the recent comments by Governor Poloz. It appears that he has changed his mind on what the monetary stance of the Bank of Canada should be. Jared Dillian of the Daily Dirtnap put it succinctly in point form after Poloz gave a speech in Kingston.

1. BoC will remain "cautious" on rate hikes
2. BoC won't be "mechanical" on policy
3. Economy has room to expand without fueling inflation

Last summer, the BoC send a clear message that the bank was ready and willing to raise interest rates because the economy was operating at full employment. Now, the BoC governor says that he is not sure if the bank should raise rates since there is still too much slack left in the labour market and the economy needs to fill 500,000 jobs.

This Week's Narrative

Data in the last week showed that:

1. Productivity might dip in the current quarter. The increase in employment seems to be rising almost as fast as the 1.9% annual rate of increase that the Atlanta Fed's GDPNow model is now projecting for first quarter of 2018.

2. Inflation is not rising faster than what is already feared. Core CPI remained steady at 1.8% y/y and wage rates ticked down to 2.6% growth y/y in February compared to 2.9% in the previous month. Modest inflationary pressure is building at the business level for the producer price index is 2.8% higher than it was one year ago.

3) Retailers continue to do poorly. Retail sales fell 0.1% in February marking a three-month slide. This suggests that consumers are taking a breather and saving the tax cut. Interestingly, the yield curve has flattened. Real rates are less negative and inflation expectations are a bit lower. This holds up well as the gold -to-copper ratio is down suggesting that the goldilocks economy is not over yet. Moderate growth combined with moderate inflation can continue. A 3.00% yield on ten-year treasuries may be a peak if the economy is cooling. Short positions are being covered and the bearish narrative has lessened.

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