Issue 12

PALOS INVESTMENT FUNDS

March 22, 2018

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Where Real Estate Meets Technology

Altus Group Ltd (TSX: AIF) is a leading provider of independent advisory, software and data solutions to the global commercial real estate (CRE) industry. The CRE industry is quickly changing as it becomes more institutionalized. Institutions continue to allocate more of their portfolios to real estate. As investors become more sophisticated and act on the global stage, data and analytics become more important. AIF is the leader in big data analytics solutions that help their clients maximize the value of their real estate portfolios. AIF also provide consulting and advisory services. Palos believes that AIF services and technology will continue to be in high demand, as real estate continues to become a larger percentage of institutions asset class allocations. AIF's flagship ARGUS enterprise software can do it all: valuation, cash flow analysis, budgeting, planning and risk analysis. The SaaS model employed by the company ensures ongoing revenue on a subscription basis.

We like the company because it has a wide competitive moat. It derives its data from proprietary cash flow information and was one of the first movers in the space. The company has an attractive growth profile and trades at an appealing valuation, particularly to its US peers.

AIF unfortunately reported a soft Q4/2017. Adjusted EBITDA was 15% below the street estimates. The stock aggressively sold off by 9%, which led Palos to investigate the name. The weakness in EBITDA came from lower-than-expected license & services revenues. We believe this was a timing issue and nothing else. The company's sales numbers were front loaded hence the large increases in Q2 and Q3 of 2017. However, even with the timing issue, Q4 was the fourth highest license & services sales quarter in the history of the company. No too shabby!!!

In our view, we see AIF as a company that has a positive growth outlook. On their earnings call, management reassured shareholders that they can continue to grow at a double-digit rate while maintaining healthy margins. AIF now trades at an attractive multiple. We view the sell off as an opportunity to accumulate the name.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.89	-2.36%
Palos Equity Income Fund - RRSP	PAL 101	$6.51	-2.47%
Palos Merchant Fund L.P. (Dec 29, 2017)	PAL 500	$4.61	15.26%
Palos WP Growth Fund - RRSP	PAL200	$9.68	-9.18%
S&P TSX Composite			-4.44%
S&P 500			-0.68%
S&P TSX Venture			-3.92%

Chart 2: Market Data*

	Value
US Government 10-Year	2.82%
Canadian Government 10-Year	2.18%
Crude Oil Spot	US $64.20
Gold Spot	US $1,328.90
US Gov't10-Year/Moody BAA Corp. Spread	183 bps
USD/CAD Exchange Rate Spot	US $0.7729

* Period ending Mar 22, 2018

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■ What is New on the Macro Level?

By Hubert Marleau

The Weekly Narrative

There is a saying in investing that when the story changes and makes a lot of media noise, investors should pay attention and asses if the noise is worthy of consideration. Over the past decade, the story about the economy has been consistent with little cause for concern. Economic growth was slow but steady, inflation was low, employment growth accelerated, productivity gains decelerated, and monetary policy was very accommodating without fiscal stimulus. The scenario brought about a two-plus-two economy (2% inflation and 2% growth), enough to increase corporate profit rates but not enough to raise interest rates. Consequently, a case of reliable stability brought a secular rise in stock prices. Some say this story is changing. For the first time in years, key factors are metamorphosing. Employment growth is rolling over. The latest Labour Department data showed that job openings rose in January to 6.3 million, the highest level on record and only 372,000 more than the number of unemployed people. In June 2015, the gap was 2.3 million. The headline inflation rate is on target as are producer prices and wage gains. Productivity is gaining speed and the Fed's monetary stance is tightening with a lot of tax-cut fiscal stimulus. Put simply, productivity is replacing employment and fiscal stimulus is replacing monetary stimulus. It looks as if we are still in a two-plus-two economy. The Atlanta Fed's GDPNow model is currently estimating that real GDP in the first quarter of 2018 will grow at the annual rate of 1.8% while the Cleveland Fed inflation model is calling for 2.1% inflation. The economy has lost the momentum of last year as consumers are feeling the effect of higher borrowing costs and lower savings. Nevertheless, the recession risk is very low. According to Moody's Analytics, the probability that there will be a recession in the next nine months is only 5%. The St-Louis Fed and many other reputable institutions agree with that prognosis. Economic expansions do not die of old age, rather they end because of an outside shock, asset bubble or a policy mistake.

The market likes stable growth over risky-high growth. High growth rates bring about high GDP volatility. Given that markets are a discount mechanism, economic stability makes their work easy as it lowers the macro risk. Under economic stability, huge moves are rare and when they occur, they are quickly fixed. There has been little economic volatility since the last recession. In one of his latest blogs, Ben Carlson demonstrated that with the use of a rolling five-year volatility on R-GDP growth rates that we are in one of the lowest volatile economic period since the late 1940s. The economy is on track to deliver gradual growth. Political volatility rarely translates into either market or economic volatility. Investing ideas and political beliefs do not mix well and are, in turn, not a profitable combination.

Moreover, valuations are not exceptional but still relatively attractive. The reduction in corporate tax rates will sufficiently boost profit per share through share buy-backs, debt reduction and new investments. These factors will keep earning yields above the cost of capital and attract money flows. Measures of market sentiment are bullish even after last month's severe stock market drop. The reliable University of Michigan sentiment survey reveals that consumers put the probability of a rise in stock prices over the next year at more than 60%. The market has not been dented by recent volatility. It should be noted that deep selloffs that are 1% or larger occurs only 10% of the time and larger than 2% only 2% of the time. Bankrate.com reported that only 6% of investors pulled some money from the stock related accounts during the January and February sell-off and 60% of investors intentionally did nothing. The bulls outnumber the bears. Coming into the first quarter of earnings season, S&P 500 companies are expected to show a year over year increase of 7% in sales and 17% in earnings. According to Factset, the tailwinds for profit increases were excellent.

Big Questions: Inflation and Trade Wars

Larry Kudlow is a globalist and a conservative economist who believes that growth come from the supply side of the economy. He advances the policy idea of adjusting capital gains for inflation and favours free trade. Despite his beliefs, Kudlow thinks that China has earned "a tough response" from its trade partners. He will influence the administration in that direction. While I do not like protectionist methods to level the playing field in trade, I've concluded that the proposed U.S. tariffs are essentially threats on Chinese producers. This could be a method to persuade China to abandon its policy of "voluntary" technology and design transfers. In this fashion, the requirement to transfer technology and designs to Chinese firms as a condition of market entry would be abolished and, in turn, reduce the cost of doing business in China. As expected, the White House is said to be considering a levy of $60 billion on Chinese

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imports targeting telecommunications, technology and intellectual property. Furthermore, the White House has proposed eliminating metal tariffs with allies that are willing to help in pressuring China to comply. Premier Li Keqiang, in a conciliatory tone hoping to quell a trade war, has said that China promises to protect intellectual property rights of foreigners. Put simply, it means China will not force foreign companies to transfer technology to domestic counterparts in their investment plans. We expect this promise to bring about actionable moves. In Geneva, the WTO members routinely complain that China violates international trading rules. During a WTO session held last December, the U.S., EU and Japan agreed to enhance trilateral cooperation in the WTO and in other forums to get China to reduce its severe excess capacity in a number of industries. It is notable that not only have Canada and Mexico been exempt from import levies on steel and aluminum, so have Argentina, Brazil, Australia, South Korea, Japan and the EU. I trust that a solution will be negotiated. If not, it could be bad. The market was down a lot today on trade fear.

On Inflation:

At this juncture, it does not appear as though inflation is about to create instabilities that will upset the boring secular trend of economic stability. Pricing signals are needed for the well-functioning of a market economy. As long as inflation does not get out of whack like it did in the 70s, the welfare costs of inflation are very affordable. History shows that the stock market does not perform differently when the rate of inflation changes. Peak performance occurs when the inflation rate runs between 1.5% and 3.0% generating average annualized returns of 18%. The same band of history shows that during periods of deflation the stock market does ok giving returns of about 5.0% but does poorly when the rate of inflation crosses 6.0%. Currently, headline consumer prices are increasing at an annual rate of 2.2% and core prices are running at the annual rate of 1.8%. It is interesting to note that during the past 25 years, the annual rate of core PCE price index averaged 1.8% and rarely above 2.0%. According to the Atlanta Fed wage rate tracker, wage growth is rolling over. The tracker which reads the earning power of labour by adjusting for changes in demographics is well off its highs from late 2016. Perhaps, the inflation fear is exaggerated. Manufacturing capacity utilization is at recession levels, the labour force is distorted by the exodus of young adults, and the corporate tax cuts could prevent businesses from raising prices. The Fed is not going to be conducive to rising inflation and the money supply growth is anemic. As one can see, there is room for more stock market returns as any interest rate increases will not likely be an outcome of inflation. The Palos' interest model which is based on historical data shows that a policy rate of 2.25% is the neutral level and that 3.00% yields on ten-year treasuries is the appropriate level for a two-plus-two economy. The BAML's Savita Subramanian examined 64 years of data to conclude that stocks have shown "a weak and inconsistent correlation" with interest rates and added that stocks are generally positive until long term rates hit 6.00%. Society General contends that the 10-year treasury is unlikely to trade above 3.00% as does Bill Gross, the bond king at Janus Henderson. In our judgement, there is no way that the Fed will allow a fast and furious liquidation of assets in a world of 2.0% growth and 2% inflation that is burdened with too much debt.

What Is Critically Important: Secular Trends and Business Cycle

(notes on a talk given at the University of Ottawa on March 15)

Of all the kind of macroeconomic phenomena, inflation, employment, productivity, trade and energy are critically important to get right. These factors are the main drivers of economic growth and they can have favourable or disastrous consequences on the market for bonds, real estate, stocks and commodities. In this regard, it is of prime importance to always question one's forecasts.

How We Do It?

Accurately predicting outcomes on the macroeconomic factors listed above is a very difficult task. Nevertheless, forecasting is an essential tool for investors to diagnose the state of the economy, ascertain the outlook probabilities, create investment strategies, justify decisions, implement them and provide accountability for actions. The latter point is crucial as the presence of persistent or significant forecast errors can damage. For these reasons, forecast often and regularly monitor all the broad market forces daily. We consistently measure them against changing market prices to see whether asset valuations are appropriate. This process assures necessary scrutiny and, in turn, helps accuracy. With new data economic points, new financial and monetary numbers, new market prices and new narratives we gradually amend our economic

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outlook and slowly adjust our investment positions. A typical forecast stock model is founded on three pillars.

1. Our starting point is valuation using conventional metrics like P/E multiples and non-conventional ones like the rule of 20 and several proprietary models. We also rely on the Fed Model.

2. We also have elaborate statistical frameworks underpinned by a) numerous market concepts like yield curves, credit spreads, real rates, neutral rates and the gold-to-copper ratio; b) economic predictors like Moody's recession risk, the Atlanta Fed's GDPNow, Leading Indicators, WSJ Survey and Cleveland Fed Inflation Nowcasting; c) economic concepts like the Palos' PPPR, Yardeni's Boom-Bust Barometer, Yardeni's Misery Index, the Taylor Rule, the Palos' Monetary Policy Index; d) financial stress indicators produced by the St-Louis Fed, the New York Fed and Goldman Sachs; e) economic indicators like the big 8: Retail Sales, Employment, Industrial Production, ISM, Personal Income, Trade Balance and Housing Starts, f) business and consumer sentiment indices calculated by the Conference Board, NFIB, Bloomberg and the University of Michigan., g) monetary indicators like bank credit, money supply and turnover.

3. Lastly, we run two models, a monetary model that is based on the Fisher truism (MV = N - GDP) and a physical model that is based on the axiom that N-GDP = employment + productivity + inflation. We also make use of various private forecasters including the Fed's economic outlook.

We acknowledge that random events, unforeseeable occurrences, and economic shocks can overtake some of the best forecasters. History is clear that interest rates and changes in asset prices are basically a function of long term trends in aggregate economic activity and business cycles. In this regard, forecasting is much more about forming a coherent economic narrative than about numerical accuracy. A good balance of data and judgement should bring about superior results. We believe that investors who are willing to put their thoughtful ideas on the line may have a comparative advantage over others who don't because the former can address why they were wrong when their forecast did not bear out and improve on their methods.

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