PALOS INVESTMENT FUNDS

March 22, 2018

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■Portfolio Management & Advisors

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Fairfax India Keeps Moving Forward

Since my last update on January 25, the company completed two deals in less than two months. This demonstrates management strong execution capabilities. Palos is pleased with the company's performance to date and looks forward to seeing what they are working on for the remaining of the year.

On February 20th, 2018 Fairfax India agreed to buy a 51% stake in The Catholic Syrian Bank (CSB) for 140 rupees per share for a total purchase price of approximately $186 million USD. The book value per share of CSB is 123 rupees. The bank was established in 1920 and offers neighborhood banking, non-resident Indian services, and small-to-medium banking services through its 421 branches and 251 ATMs across India. CSB serves 1.5 million customers. This deal will mark the first time a financial investor takes control of an Indian lender which shows how highly regarded Fairfax is by the government and business community. FIH has enough capital to fund the deal without raising money.

On March 29, 2018 Fairfax India announced that it has entered into an agreement to acquire an additional 6% of the outstanding shares of Bangalore International Airport Limited. Fairfax India currently owns 48% of the airport and upon completion it will own a controlling stake of 54%. Palos believe that this transaction is at a great value as it's coming at discount to the last transaction.

Palos continues to believe that FIH.U is the best way to get exposure to India. You get a stellar management team that has over 20 years experience investing in India and access to assets that you could not get as an individual investor.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.63	-2.95%
Palos Equity Income Fund - RRSP	PAL 101	$6.38	-2.90%
Palos Merchant Fund L.P. (Dec 29, 2017)	PAL 500	$4.61	15.26%
Palos WP Growth Fund - RRSP	PAL200	$9.46	-11.24%
S&P TSX Composite			-4.52%
S&P 500			-0.76%
S&P TSX Venture			-6.30%

Chart 2: Market Data*

	Value
US Government 10-Year	2.74%
Canadian Government 10-Year	2.09%
Crude Oil Spot	US $64.92
Gold Spot	US $1,325.00
US Gov't10-Year/Moody BAA Corp. Spread	185 bps
USD/CAD Exchange Rate Spot	US $0.7760

* Period ending Mar 29, 2018

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■ What is New on the Macro Level?

By Hubert Marleau

The Weekly Narrative

There is empirical validity that secular economic trends and business cycles are two major determinants of stock, bond, commodity, and real estate market returns. However, short term narratives can have tremendous consequences on daily and weekly performances. Recently, we've seen the market impact of narratives about trade wars, tech regulations, tax cuts and inflation fears. Narratives make markets. Over the past three months, we had an unusual abundance of stories some of which had favourable short term market effects while others had unfavourable ones. It's hard to figure out what is really going on. There are three narratives that are circulating in the media: the Fed may increase interest rates more than they should, money traders need to test the February lows and that a trade war between the U.S. and China could erupt. Sharp shifts in market narrative make investors nervous as it creates needless uncertainties. Fundamentals and rationality will return.

US Monetary Policy: Still Accommodating

There are a few things that we know with certainty about the way the Fed behaves under different economic circumstances. The Fed has always raised interest rates when inflation is near the 2.0% target and when the unemployment rate is approaching the assumed 4.5% full capacity level. The U.S. economy has been in this position for some time. Accordingly, we have had several rate hikes since December 2015. Presently, the federal funds rate is 1.625%. The Fed believes that the current monetary stance remains accommodative, thereby supporting strong labour conditions and 2% inflation. Interestingly, the odds that there will be three more hikes are withering. That tells me that the selloff did not occur because of inflation fears. As a matter of fact, inflation expectations have moved down a bit to 2.05%. This morning on March 29, real rates for three-month bills were negative 56 bps, the yield curve was upward sloping by 54 bps and the federal funds rate is 75 bps lower than the natural interest rate of 2.25%. Additionally, the ten-year treasury yield is 170 bps lower than the current year-over-year 4.5% increase in N-GDP and 1.30% lower than the annual increase of 4.1% in the money supply. Moreover, the copper-to-gold ratio strongly suggest that ten-year treasury should only yield 2.50%. Put simply, we might only be getting one more rate hike in 2018. I do not believe that the Fed will allow the market to form an inverted yield curve. There has been a slowdown of economic momentum for most measures of economic activity show that the growth rate has rolled over. Moody's high frequency model for world economic growth has reduced its estimated for the first quarter of 2018 to 2.9% to from a high of 4.1% in January. The Atlanta Fed reduced its estimate for the U.S. from a high of 5.4% to 1.8%. Nevertheless, recession risks remain low. The chance of entering a recession over the next nine months is less ten percent. The Chicago Fed National Activity Index had a strong showing in February and consumer confidence, albeit lower than its highs, is very optimistic. It should be noted that the mixture of a low exchange value of the dollar and favourable interest rate differentials with the rest of the world have reached levels to attract foreign capital. For example, U.S. bond yields are 230 bps higher than comparable bonds in Europe and the dollar index is 89.50 making the U.S. capital market very alluring for foreigners to finance the twin deficits.

Market Technicals: Resistance at 2575

It is not unusual for the market to test recent lows to see if there is a line of defense. Last Friday, the S&P 500 closed very near the 200-day moving average and touched the lower level of the trend channel of the 2017 rally. These are two points of resistance. On Monday, the 200-day moving average proved once again to be hard to crack. We saw the S&P 500 post its biggest one-day gain since August 26, 2015. It looks as if the selloff is more the product of a correction of valuations than the beginning of a bear market. The secular upward trend may be intact, but volatility is the new normal and the new narrative. In the final trading hour on Tuesday, stock prices took another bad turn as fast money funds sold. The S&P 500 slipped 1.7%. Financial stocks were hurt by a solid decline in bond yields and tech stocks were hammered by the overblown bursting of overconfidence and a possible regulation change in the tech sector. On Wednesday, the trading session was once again dominated by tech fright. History shows that when a sector becomes dominant, it attracts the taxmen and the regulators. This sector can easily be hurt as value is basically based on intangibles like reputation and brand. Outside these two sectors, the prospects of rising earnings are good. Analysts could be underestimating earning growth as N-GDP is still rising faster than Unit Labour Cost, a reliable proxy for S&P 500 EPS. While volatility makes us nervous, it has shaken my conviction to buy the dips. The correction has made valuation metrics

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on a prospective earnings significantly more attractive and the market response to the tariff tantrums is totally disproportionate to its economic impact. In a historical context, the tariff situation is not that shocking when compared to the possibilities of collapse of the eurozone, default on the S.S. Treasury debt and a financial crisis in China. And, we went through these rather quickly. The bottom line is that the technical sentiment did not break. The market has a few good aces in the hole. The Rule of 20, the Dow Theory, the ROE is a healthy 18.5% and the PEG ratios for value and growth stocks indicate that the uptrend in stock prices is still in force. The BAML compiles a set of 19 indicators that have preceded past bear markets. The indicators suggest the risk of a reversal is not imminent. The current volatility is not a warning, it's just volatility. Incidentally, Palos' 2018 year end forecast of 2850 for the benchmark is intact; that's 5% below the median forecast of 24 firms surveyed by Bloomberg.

Calling a Trade War is Premature

Tariffs are directly inflationary, yet bond yields are lower everywhere in the world. Additionally, the US dollar is still falling. Interestingly, the copper-to gold ratio calls for lower long-term yields and a higher dollar. There is optimism that a deal can be reached with China to avoid the need to follow through with Trump's threat to impose import tariffs on Chinese goods. Headlines read that China and the U.S. are committed to have wide ranging discussions on how to improve U.S. access to the Chinese market and find a mutually agreeable way to reduce the trade deficits. A solution between these two rivals may be simpler than it appears. When adjustments are made for services and re-exports the deficits are not as large. Not only is China more vulnerable than the U.S., the aforementioned adjustments bring down the deficits with China to $148 billion from $376 billion. The idea of using Teddy Roosevelt's "Carrot and Stick" may work. South Korea has already agreed to amend their trade pact with the U.S. and NAFTA is on the fast tract. This seems like a normal Trump playbook. There is a realization in the marketplace that protectionism can be lethal to growth. Protectionism has been of little concern for macroeconomists in their simulations. The OECD, the World Bank , the IMF and Goldman Sachs shows that an overall 10% tariff rate from the 2% that exists today would bring about a 3% reduction in global output over several years. It is well known from the classic "Prisoners' Dilemma" that the imposition of retaliatory measures will gravitate the governments toward a bad Nash-Equilibrium even when a good equilibrium is available through co-operative behavior. In order to avoid a catastrophe, China and the U.S. are reformulating a new deal and President Trump is backtracking on the metal tariffs. The general population in the U.S. is not supportive of Trump's trade measures. A WSJ\NBC News Polls show that less than 25% of the adult population thinks that foreign trade is a threat.

Oil Prices: Showing Independence

Oil prices held up well despite the volatility and setback in equity markets. The global oil complex shrugged off geopolitical risks. Hedge funds ratcheted up bets that crude prices will during the selloffs believing that rising demand and reduced production is on.

Jittery Powell: The Fed's New Mission

The Fed under the governorship of Jay Powell will try to engineer the best economy since the 1960s without much regard to conventional economic theory. History is not on his side. Raising employment levels when the economy is near or at full employment without triggering a recession is a risky project. The Fed policy makers produced new economic projections showing that the median expectation for GDP growth is 2.7% in 2018 and 2.4% in 2019 and for the unemployment rate to slip further towards 3.8 % by year end. That compares with 2018 and 2019 GDP forecast of 2.0% in September before President Trump signed into law the massive tax cuts and made a deal with Congress to increase federal spending by $300 billion over two years. Fed economists think that inflation will breach the Fed's 2% target by the slightest of margins only in late 2020. For this to happen, there would have to be potential workers wanting to join the labour force despite a demographic pull down or an enormous increase in productivity stemming from companies willing to step up investment, en mass, in response to the tax cut new technological measures. It is also possible that the Fed feels that there is a lot more unused industrial, technology and human capacity than generally believe. All of this might be true. It's not clear because the Fed has calculated that that the fiscal multiplier for this year is 0.45 meaning that every dollar of fiscal stimulus from tax cuts and increases government spending is buying 45 cents of extra growth. Meanwhile, the Fed's implied fiscal multiplier for 2019 is only 0.2%. Monetary authorities offer little evidence that productivity is about to surge. In our judgement, it is impossible to have 2.0% inflation

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and no increases in productivity. In others words, Powell is willing to let the labour market and general inflation tell him when the slack in the economy is gone. He is not tied to models or theories but more inclined to take signals from incoming data. Powell will know the economy is changing when he sees it. This sounds like Greenspan. This is based on the notions that "the future ain't what it used to be" and that "we should let it rip." While medium term business cycle forecasts should not be taken too literally, it appears that the Fed will be tolerant. The anticipated pick up in productivity may help to keep a lid on inflation. When one adds in price competition enabled by online retailing, global supply chains, and higher profit margins, there is hope these powerful forces will keep inflation down. The bottom line is that the FOMC is telling us that PCE inflation will not hit 2% any time soon, and that when it does the Fed won't get nervous. The monetary authorities might have a point. Business investments are about to soar according to the Regional Fed Surveys. The Capex Investment Plan Index produced by Morgan Stanley and the Business Investment Tracker produced by Bespoke Research are suggesting the same. A lot is riding on this. If the economy is going to expand as fast as the Administration hopes and the Fed thinks it will without triggering higher inflationary pressure we'll need a pick in productivity.

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