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PALOS

Weekly Commentary

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By Charles Marleau, CIM

Volatility Update

To say the last few weeks have been tumultuous would be an understatement. COVID-19 and the oil collapse has brought unpresented fear and volatility in the equity market. OPEC+ held a meeting on March 6 in Vienna. It was universally expected that an agreement would be reached to temporarily cut production by 1.5 million barrels/day, in order to support prices. In a shocking announcement on Saturday, we learned that Russia was not willing to comply.

OPEC+ Update

The immediate pushback from Saudi Arabia was the announcement that all production cutbacks would be lifted at the end of March, thus flooding the market with supply. This was clearly a retaliatory measure intended to hurt Russia. The result: futures prices for Brent crude (European pricing) and West Texas Intermediate (U.S.) tumbled over 25%. This was the worst performance in the crude oil futures markets since 1991 (Gulf War). **These are extreme moves by any historical measure and unlikely to sustain for the long term.** Russia's refusal to comply has been painted as a strategic maneuver by Vladimir Putin to destroy the explosive growth in U.S. shale production. Geopolitics have taken over from fundamentals. Most would think this will only have a negative affect on oil & gas producers, but such a shock will be felt across many industries. As oil & gas capital expenditures will surely be reduced, it will be felt throughout engineering, transportation, steel, construction, rail, and energy services companies. On the other hand, lower energy prices should help consumers and industries that are energy intensive like airlines, trucking and mining. However, these benefits are being overshadowed by the COVID-19 fears.

By Charles Marleau, CIM

COVID-19 Update

On March 9, 2020. I received a report from a well-respected Wall Street firm whose name I cannot publish. I have noted the important points as mentioned in the report (see below) and my take on it is this. There are early signs that the virus has peaked at the epicenter of the outbreak as new cases have plummeted. Recoveries are escalating. From this information we can extract a probable scenario for Europe/North America: this should run its course in due time (estimate of 2 - 3 months based on China data). We have seen the same outcome from SARS, MERS, H1N1, Ebola etc. This leads me to believe that the worst is behind us for China. Europe/North America will surely follow but this will require time.

- Uncertainty for the short-term has not diminished, nor has media sensationalism
- There is no imminent sign of a turnaround in Europe/North America
- Markets are trading at extreme levels of pessimism as measured by divergence from the mean
- Fatalities seem to be limited to persons with pre-existing conditions and of advanced age
- Fatality rates are currently around 3.5% (SARS 10%, MERS 34%)
- We are starting to see indications that economic activity in China is on the rise

The Positive News

- The report speculates that GDP growth will slow in Q1, but accelerate in Q2 and Q3
- Interest rates will be cut further (an economic stimulus)
- Lower rates for longer will eventually lead to a shift from bonds to equities
- Quantitative easing and economic stimulus programs are likely to come
- New cases in China have been decelerating since mid-February and recoveries are increasing
- Clinical trials testing the safety of a vaccine will begin this week

In terms of the COVID-19, it’s clear that we are in the eye of a category 5 storm. Fears have become rampant and indiscriminate selling is seriously overdone. The COVID-19 event will be transitional, and the world will get back to normal, the issue is no one knows how long it will take. The uncertainty is what driving the panic and volatility.

By Charles Marleau, CIM

How the Palos Income Fund is Weighted by Sector:

Market	Palos Income Fund	TSX	Palos Top Four Positions By Sector
Communication Services	4.00%	5.50%	T, QBR/B
Consumer Discretionary	6.50%	4.00%	DOL, QSR, PLC, PBL
Consumer Staples	10.00%	4.00%	WMT, ATD/B, SAP, JWEL
Energy	12.50%	16.00%	SU, ENB, PPL, KEY
Financials	23.00%	32.00%	RY, BNS, NA, TD
Health Care	2.50%	1.00%	SIA
Industrials	15.00%	11.00%	CNR, CP, KBL, TFII
Information Technology	5.50%	6.00%	GIB/A, KXS, LSPD,OTEX
Materials	8.00%	11.00%	CCL/B, LUN,NTR, SQM
Real Estate	8.00%	4.00%	BEI-U, CRR-U, D-U, TCN
Utilities	6.00%	5.50%	CPX, INE, NPI, SPB

What to Do:

Remain disciplined: Ultimately, we will recover from this crisis and the recent correction will one day be a distant memory. We should also remind ourselves that buying when prices are depressed is the only way to profit in the markets. However, being overly brave and hasty should be avoided. Eventually we will get our chance to buy. In the meantime, we also want to avoid catching the proverbial falling knife. Our course of action will be to **slowly add to positions in high quality stocks** that have been unfairly punished (e.g. Utilities, Telcos, Real Estate, and Financials). These stocks will be the first to move higher once markets stabilize.

Keep a level head: Don't panic and don't obsess with your portfolio. By doing do you are simply subjecting yourself to the temptation to sell an asset below its fair market value. No doubt, this is hard to do but I assure you that our strategy of being well diversified and **maintaining a long-term perspective will be rewarding.** Investing is a long-term proposition and reacting to short term volatility will surely lead to doing the wrong thing. Remember, only a few weeks ago markets were doing fine.

Use history to our advantage. When we experienced the SARS epidemic, we saw drawdowns down in the S&P 500 of roughly 7.5%, followed by an 18.3% recovery by the end of 2003. With H1N1, the drawdown was 9.1% and followed by a 26.3% recovery in the six months following the epidemic. After 9/11, the market drew down 13,8% but quickly recovered in the following two quarters. Markets will correct from time to time and while this can be unsettling, it is perfectly normal. **Corrections ultimately lead to opportunities.**

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$6.47	-23.86%
Palos Equity Income Fund - RRSP	PAL101	$4.54	-20.55%
Palos Merchant Fund L.P. (Dec 31, 2019) [2]	PAL500	$1.71	20.15%
Palos WP Growth Fund - RRSP	PAL210	$5.04	-34.15%
Palos-Mitchell Alpha Fund (Fund Initiated on Jan 29, 2019) [3]	PAL300	$7.63	-26.41%
S&P TSX Composite (Total Return with dividends reinvested)			-19.10%
S&P 500 (Total Return with dividends reinvested)			-15.73%
S&P TSX Venture (Total Return with dividends reinvested)			-32.24%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			0.96%
Canadian Government 10-Year			0.85%
Crude Oil Spot			US $31.73
Gold Spot			US $1,516.70
US Gov't10-Year/Moody BAA Corp. Spread			328 bps
USD/CAD Exchange Rate Spot			US $0.7243

[1] *Period ending March 13, 2020. Data extracted from Bloomberg*

[2] *Fund is priced annually*

[3] *Fund is priced weekly on Tuesdays*

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