PALOS
INVESTMENT FUNDS

October 12, 2017

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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

Bechara Haddad
Portfolio Manager

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

Los Angeles Orders More Buses

On October 10, 2017, New Flyer Industries (TSX: NFI) announced the introduction of its next generation battery-electric heavy-duty transit bus. The new and improved Xcelsior bus will now be available in 35, 40, and 60-foot models. The new Xcelsior has extended battery range technology that enables travel of 200 miles on a single charge. The motor also has regeneration energy recovery and the highest torque available which makes it compatible for steep grade cities such as San Francisco. In addition to zero emissions, passengers will experience the quietest bus ride possible.

LA metro awarded a contract to NFI for up to 100 60-foot Xcelsior Battery-electric busses. The contracts include 35 firm orders with options to purchase an additional 65 buses. The decision follows LA's commitment to making all transit busses electric by 2030. We believe that this is the first of many orders from LA Metro as the city makes its transition to an electric fleet. We believe that many other cities in the US will follow as they see the health and noise pollution benefits as well as the long-term energy and maintenance cost savings.

NFI trades at an attractive 8x EV/EBITDA 2018 estimate. Palos believes that the street's long-term growth estimate is too conservative. North American cities are at the beginning of their eventual adaptation to electric buses. In the next decade, we believe that cities will pledge faster adoption of electric buses as the benefits become increasingly clear.

■ What is New on the Macro Level?

By Hubert Marleau

U.S. Stocks Still Have More Rome To Run

Predicting bear markets is an extremely difficult feat. It's darn hard and it's a rare occurrence. Sir John Templeton wisely said, "bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." While the phrase has appeal, it's not empirical enough to fit into an equation or a set formula. The school of behavioral economics is not advanced enough to predict human actions and public sentiment. Work in this domain is still at an experimental stage. Nevertheless, there are a few facts about the

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.77	6.45%
Palos Equity Income Fund - RRSP	PAL 101	$6.42	5.53%
Palos Merchant Fund L.P. (Jun 30, 2017)	PAL 500	$4.22	5.65%
Palos WP Growth Fund - RRSP	PAL200	$10.48	4.81%
S&P TSX Composite			5.26%
S&P 500			15.76%
S&P TSX Venture			55.56%

Chart 2: Market Data*

	Value
US Government 10-Year	2.32%
Canadian Government 10-Year	2.08%
Crude Oil Spot	US $50.68
Gold Spot	US $1,293.30
US Gov't10-Year/Moody BAA Corp. Spread	197 bps
USD/CAD Exchange Rate Spot	US $0.8015

* Period ending Oct 12, 2017

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market that are interesting to note. Since 1900, the DJIA has spent over 75% of the time either "falling" (34.4% of the time) or "recovering from a loss" (41.5% of the time) and just 24.1% of the time "making new wealth". At present, the market is making new wealth. History shows that from 2000 to 2013, the market was boxed in and new wealth was produced only from 2013 onwards. The last time that the stock market provided new wealth was from 1983 to 2000. It lasted 17 years. Moreover, investors who bought the S&P 500 when it hit its top on October 9, 2007, and held on through the subsequent panic and market collapse, have more than doubled their money. In fact, they have performed not much below what the market has delivered throughout history. The S&P 500 has returned 5.6% above inflation since October 9, 2007 compared to a return of 6.5% over the previous century.

Firstly, concerns abound because it's been a very long bull market. While cycles naturally age, there have been several long bull markets in the past. Bull markets don't simply end for no reason and they do not operate on a set schedule. The February 1961 to December 1969 bull run lasted almost nine years and the November 1982 to July 1990 lasted almost eight years. We believe that we are in the seventh inning. In other words, the current expansion may last another two years and become the longest bull market in recorded history. Take note that innings can last a long time. We still have low inflation, corporate earnings growth and global synchronized GDP growth; and it will take a decade or more to remove the $15.0 trillion of monetary stimulus that has been provided by central banks. Outside of the U.S., the ECB and BOJ are still buying financial assets. BlackRock Investment Institute has looked at all the U.S. economic cycles since 1953. What stands out is that the US is in a normal cycle and is closely tracking the two previous cycles. This cycle's remaining lifespan can be measured in years as a lot of economic and financial activity is trending in the right direction.

Secondly, concerns about valuations are widespread because they are above their long-term averages. Indeed, valuations do not look cheap when we compare them to their historical levels. In this regard, we are probably a bit further along in the cycle and, therefore, a short correction might be imminent and indeed welcome. The average stock is presently trading with a P/E ratio 75% above its historical valuation. That is two standard deviation above the mean. In 2000, P/E ratios were as high as 164% (four standard deviations) above the mean and in 1929 it was 95% (three standard deviations) above the mean. When it comes to the Buffett Indicator (Corporate Equities to N-GDP) and the Tobin's Q (Market Capitalization to Replacement Cost) the story is pretty much the same. While these observations are compelling on the surface, they do not take into account the circumstances of the time and they do not obey the rules of economics. In 2000, the Federal Funds Rate was 6.50% and Baa seasoned corporate bond yields were 9.00%. In 1929, Baa seasoned corporate bonds were yielding 11.0%. Put simply, bond yields were running much higher than earning yields (inverse of P/E) and were considerably higher than annual changes in N-GDP. Today, the economic and financial regimes are significantly different. It's not that this time is different, it's simply that we are not yet there. Currently, stocks have, on average, earning yields of 5.20% which is 290 bps higher than ten-year government notes (2.30%). Furthermore, federal funds rate, ten-year treasury bonds and top graded corporate bonds are trading for yields that are less than the pace of increases in N-GDP (4.00%). From this perspective, the stock market does not appear exorbitantly priced. On the contrary, there is still plenty of fuel left. Ed Yardeni, one of my favorite economists and one that has been right about the market since the lows of 2009, thinks that U.S. stocks have not yet reached "excessive overvaluation". His method is simple; he subtracts year-to-year percentage changes in consumer prices (1.90%) from the current earning yield (5.30%) to arrive at a real yield of 2.40%. Believe it or not, that is the smack on real growth and around the historical mean.

Thirdly, there are a lot of worrisome world events causing anxiety and fear. Fortunately, the number of geopolitical events and terrorist incidents that have caused major disruptions or turning points in either the economy or markets are quite rare. While the alarming headlines may move the markets day to day, traders, quant models and ETF players tend to reprice stocks and normalize trends by buying the dips. There is an awareness in the marketplace that ugly situations such as the "North Korean Crisis" will need to be resolved or accepted at some point and that some kind of status quo will be established.

Fourthly, the "China Debt" story is very much on the mind of investors because China is a key driver of global growth. A lot of the debt in China belongs to households and businesses. A considerable amount is collateralized with assets whose profitability and/or utility is above the debt service charges. In any case, China could turn

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some of the sustainable bad debt into sovereign debt. China has huge amounts of official reserves and full government coffers and therefore, has the buffer to transfer private debt to the public sector like the U.S. did during the financial crisis.

Lastly, the monetary stance of the Federal Reserve Bank is changing and the outcome could turn into a policy mistake. The Fed's narrative is that the normalization process will be slow. There are two points to consider: will the Federal Funds Rate end up above the Neutral Rate that we established at 2.00% and will ten-year treasury yields reach the ongoing year-over-year four percent change in N-GDP? Presently, the gaps are sufficiently wide and the economy could accept narrower spreads.

Even though aforementioned arguments refute concerns that investors have, we spend a lot of time devising indicators and looking at signals that may trigger a bear market by being more empirical than philosophical about what is going on. Obviously, we do not have a crystal ball to predict the next 12 to 18 months with accuracy or specificity. But, we do know a few important things. Ben Carlson, a savvy writer on financial affairs, observed that since the second world war, 10 out of the last 12 recessions saw the S&P 500 go into a bear market within 12 months of an economic slowdown. Stocks do not like recessions and they react very negatively when they come around. In the last 100 years, there have been 14 recessions and on average, they last for about nine months. Put simply, we are in recessionary periods about 3.0% of the time. I must say that a lot of time and energy is spent on trying to pinpoint what is in fact a relatively rare occurrence. Additionally, if one was to tabulate stock market performance six months prior to a recession and twelve months after one ends, one would have done better than the benchmarks 78.5% of the time. What makes it even more difficult, is the fact that we usually never know if we are in a recession or about to enter one. While I realize from my readings on behavioral science that investors put more importance on risk aversion and on opportunity gains, rationality and discipline clearly indicate that it's better to play outside and take risks than to stay home and avoid risk. Nevertheless, we watch indicators closely that have served us well in the past and have allowed us to cautiously calibrate our managed portfolios and our funds to mitigate disasters. In doing so, we sacrifice some market returns; but we sleep better at night and still see satisfying performance. We closely monitor five indicators:

- The Federal Reserve Bank of Atlanta has a GDPNow model that forecasts real GDP growth on the run. It's great because it tracks what is going on in the economy before the official statistics are released by the BEA. On October 12, the model forecast that real growth in the third quarter was 2.5%. Moody's Analytics has also running a high frequency measure of an economy's performance in a timely way. Moody's is more bullish. Its model shows 3.3% GDP growth. The NY Fed has their own similar indicator. What we like about these models is that they aggregate data on a continuing basis and give a clear, concise and immediate picture of what is happening on a macroeconomic scale.
- Moody's Analytics has an index named risk of recession. It monitors the formation of macroeconomic imbalances, the status of the economy's balance sheet, employment conditions and inflationary considerations. It shows that the probability that that the U.S. economy will fall into a recession in six months is very low at 8.0%. The WSJ has a different index that does a similar job by polling the opinion of many independent economists. The survey shows that the risk of a recession for the next twelve months is only 15%.
- The Misery Index is also a very useful tool. At its base, the economy's health is always about inflation and employment. The index is made up by adding the unemployment rate and the yearly percentage change in the consumer price index. While simple, there is a close relationship between the misery index and stock market cycle. Since 1948, bear markets have always been associated with a high and rising misery index. The point is that the market does not like rising unemployment and/or rising inflation. Currently, the misery index stands at 5.1. History shows that bear markets start when the index is around 8.0 or higher and rise from that base.
- We also like the "Rule of 20". It's simply, the S&P 500 forward P/E plus the year over year percentage increase in the CPI. History demonstrates that when the index is higher than 20, there is an above average chance of a bear market occurring. Currently, the index stands at 20 which is neutral territory. Should profits fall or inflation rise, the market could head towards trouble. Despite a lot earnings revisions reflecting the impact of hurricanes, earnings are expected to increase in the September quarter by 4.8% year-over-year and accelerate to 11.8 % during the December quarter.

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- Lastly, we monitor the daily performance of copper prices and the yield curve. It's noticeable that bear markets in stocks have never occurred without a sharp and sustainable drop in copper prices and/or without a persistently negative yield curve. Currently, copper prices are up and the yield curve is positive.

P.S. "The first WSJ forecast for stocks in 2018 has arrived. The verdict? Bullish. On all the strategists tracked by Birinyi Associates, Credit Suisse, Jonathan Golub so far appears as the most accurate, he forecast the S&P 500 will rise to 2875 by the end of next year, a 13% move over the next 15 months".

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