

August 3, 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

## ■ 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](http://www.palos.ca)

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## Palos Weekly Commentary

### ■ Palos Funds

By Charles Marleau

#### Cineplex (CGX)

The Palos Funds sold their last shares of Cineplex (TSX: CGX) yesterday after the company announced very disappointing second quarter earnings. What is more concerning however, is that the legacy business is under significant stress. Cinema advertising and box office revenue growth was lackluster and quite troubling. The majority of CGX revenue growth came from its acquisitions of TriCorp, Saw, and Dandy, which are amusement businesses. We believe these companies to be more capex intensive and more expensive to run as we expect operating expenses, G&A, and rents to rise considerably.

Our fear is that the legacy business is in trouble as consumers and advertisers are changing their behavior and preferences. Millennials and Generation Z now make up the bulk of entertainment consumption. These two

generations spend more time on YouTube and Netflix than any other. Streaming is becoming the new norm and going to the movies at a specific time is less appealing. Furthermore, advertisers are probably getting more from advertisements on YouTube than on the big screen. The big screen is under some serious pressure due to streaming and the change in consumer behavior. Is CGX's legacy business the next Yellow Pages? Will the move to the amusement business be successful? I don't know, but I prefer not being an investor once its fate is sealed. We believe that CGX diversifying away from its legacy business will be long, expensive and risky.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	\$9.40	0.34%
Palos Equity Income Fund - RRRP	PAL 101	\$6.23	0.77%
Palos Merchant Fund L.P. (Jun 30, 2017)	PAL 500	\$4.22	5.65%
Palos IOU High Yield Fund (May 31, 2017)	PAL 701	US \$7.00	-3.83%
Palos WP Growth Fund - RRRP	PAL200	\$9.78	-2.24%
S&P TSX Composite			0.99%
S&P 500			11.72%
S&P TSX Venture			50.72%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			4.54%

**Chart 2: Market Data\***

	Value
US Government 10-Year	2.22%
Canadian Government 10-Year	1.90%
Crude Oil Spot	US \$48.93
Gold Spot	US \$1,267.60
US Gov't 10-Year/Moody BAA Corp. Spread	205 bps
USD/CAD Exchange Rate Spot	US \$0.7945

\* Period ending Aug 3, 2017

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## ■ What is New on the Macro Level?

By Hubert Marleau

### On the U.S. Economy

The Commerce Department reported last Friday that the U.S. economy rebounded in the June quarter after a very slow start entering 2017, bringing the annual rate of growth to 3.7% including inflation. The latest figures show that the U.S. GDP is doing the same as it's been doing for the last eight years: steady but modest growth. Since the end of the second world war, there has been 12 economic expansions and the one between June 2009 and June 2017 has so far been the third longest, the weakest, the least volatile and the most uneven. On this later point, nearly three quarters of the U.S. counties have not fully recovered on local unemployment, job creation, economic output and home prices. Nevertheless, as the points below illustrate, the economy is plugging along:

- In physical terms, inflation accounted for 1.6% of the overall year over year increase of 3.7% while employment and productivity growth increased 1.3% and 0.8% respectively. GDP in real terms rose 2.1% year over year.
- In monetary terms, transactional money supply with zero maturity (M2M) increased 5.0% in the year ended June 2017, while its turnover decreased 1.3%. It should be noted that persistent declines in the turnover of money is either associated with falling inflation, declining productivity or the accumulation of money (hoarding) or a combination of all three. Put simply, not all money is put to use in the economy. An important chunk of the money supply is dead and/or directed to the domestic and/or international capital and money markets.

The question is whether the recovery will last and for how long. This question is particularly important to investors who see their prospects rise and fall with GDP changes. From our point of view, the economic train should keep chugging along and is unlikely to die of old age. It seems to us that the economic upswing is mature but healthy. An economic recovery does not end on an arbitrary date. A 2016 study from the San Francisco Fed also concluded that “expansions during the past 70 years do not become progressively more fragile with age.” More often than not, imbalances are the cause of recessions and they are rare when growth is mediocre. Generally speaking, consumers and businesses are in good shape and there are no serious problems

in the financial system. Short-term economic indicators like the St-Louis financial stress index and Moody's recession risk index are not suggesting that a downward correction in the level of business activity is imminent or foreseeable for the next twelve months. As a matter of fact, there seems to be enough desired demand to absorb the readily available supply of goods and services, making it possible to grow the economy without overheating. This business cycle expansion is long in the tooth. but not in any serious jeopardy.

The following are some important details on the current state of the US Economy that support our thesis.

- Cyclical expenditures, like consumer spending on durable goods, residential construction, business investments and inventories, that are sensitive to interest rate changes, account for 27.0% of R-GDP or \$4.6 billion. In current dollars, about \$5.2 billion of savings is needed to fund these expenditures. Given that 12.5% of the capital needed to fund these cyclical expenditures comes from abroad, it is not a difficult task for domestic savers to oblige. As a rule, there is no excess demand of productive and utilizable goods when cyclical expenditures are less than 30% of aggregate spending.
- Businesses hate to finance unsold inventories without the assurance of new orders. Consequently, many operators, big and small, have introduced efficient inventory management to alleviate this problem. There has never been a recession without large accumulations of unwanted inventory. Inventories are not often discussed by analysts when the GDP numbers are printed. It does not mean that they are unimportant. Interestingly, there has been no change in inventory levels in the last six months.
- The economy is not operating at its full potential and therefore Americans are not in a pressure cooker. For the economy to be at full employment, work participation would have to be at a much higher level, people over 65 years of age would have to leave the labor force and the cost of employing labor would have to increase considerably faster than the combination of gains in productivity and inflation which totals 2.4%. Both indicators are currently on target at 2.4%. Our statistics conclude that full employment is an unemployment rate of 3.5%. Currently the the unemployment rate is around 4.5%.
- While we recognize that the Fed will raise rates and shred its earlier bond purchases, there is no way that the monetary authorities

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will go much beyond normalization. The Palos monetary policy index is falling, the inflationary content of the misery index is declining, cyclical expenditures are too low and productivity needs to be boosted with more business investment in equipment and intellectual property products. An even keel monetary stance is all that is needed. Based on current economic conditions, the upper end of long capital rates and short money rates should not be any higher than 2.75% and 1.375% respectively.

- The average American spends only 2.0% of his personal disposable income on gasoline and other energy goods. Past recessions have often been triggered by higher proportional expenditures on energy like 3.5% to 4.0%.
- While the official profit numbers for the third quarter are not out yet, early indications are very promising. American companies are on track to achieve two consecutive quarters of double-digit profit growth resulting from cost-cutting, a weak dollar and rising consumer spending. So far, the earnings of S&P 500 companies are expected to rise 11% from the June quarter of 2017 over the comparable period of 2016. The gains seem to be spread across all industries except utilities. History shows that rising corporate profits combined with good profit margins are usually a healthy omen for future economic growth.
- GDP output remains 15% below the pre-2007 trend line; a gap that should be considered wide if one believes that former growth was attainable. In this connection and if we were to recapture the lost 15%, at 2.0% annual growth, we have another 7.5 years to go before a recession hits. It's a foolish and fake argument but not preposterous.

Accordingly, there is nothing out there, like enormous imbalances, that represents an imminent threat to the ongoing expansion or potential complications that could drag the economy into a recession. The internal drivers of the economy are on solid footing and only an external shock, like a global trade war or a serious geopolitical event, could derail it.

## On U.S. Monetary Policy

The Fed is expected to deploy a monetary stance that will bring about full employment while making sure that the measures used will not overheat the economy with too much inflation. In this regard, it is imperative for investors to closely monitor what is going on with current inflationary conditions and the employment situation.

- The Unemployment Rate (U.R.) is not always accurately revealing or informative because it does not take into consideration the Labor Force Participation Rate (LFPR). For example, a low employment rate when the LFPR is low is quite different from when the LFPR is high. If the LFPR was the same as it was a decade ago, the U.R. would be close to 8.0%, far from the 4.5 % unemployment rate that the Fed considers as full employment.
- Inflation has taken a step back in the first half of this year. The headline Personal Consumption Expenditure (PCE) deflator was unchanged in June and has not budged for two consecutive months. On a year-ago basis, the headline PCE deflator was up 1.4% and the core PCE deflator, which excludes food and energy, rose 1.5%.

Put simply, the above facts are complicating the work of the Fed. Several Fed officials have expressed concern about pushing ahead with more interest-rate increases. In our judgement, it is more important to steepen the yield curve with bond sales than to raise the cost of money. The growth potential of the economy is much lower than it used to be. This is related to depressed investments; a way to get around this problem is with a steeper yield curve. It may prove to be helpful in attracting capital to sectors like infrastructure and to fix business formations. Capital needs to be re-directed from durable goods and residential construction to more productive investments.

*If you have any questions about the weekly commentary, the securities that we follow, or investment ideas, please contact us at [info@palos.ca](mailto:info@palos.ca)*