Issue 38

PALOS
INVESTMENT FUNDS

September 21, 2017

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Offshore Wind Power

Northland Power Inc (TSX: NPI) is emerging as a leader in wind power. NPI's operating capacity is 1,754 MW, and of that amount, 696 MW is being attributed to wind. NPI is continuing to expand its wind portfolio, especially offshore. At the end of the year, NPI will be commissioning the Nordsee One offshore project. This will bring about a net increase of 285 MW to the portfolio. NPI is also working on their 252 MW Deutsche Bucht offshore project; its commissioning is planned to take place at the end of 2019. NPI is thriving and becoming a leader in the offshore wind power sector. After speaking with management, we believe the next offshore wind expansion will take place in Asia. We view this positively as this probable expansion would diversify the company's offshore portfolio away from Europe. Why is Asia a good candidate? Taiwan and other Asian countries are implementing government incentives that are very similar to those currently implemented in Europe. We are optimistic that NPI can win many Asian contracts in the coming years as it has the skill, the knowledge and the experience of offshore wind projects. It is difficult to quantify the size of this opportunity. However, Asian countries are moving away from coal and nuclear power and transitioning to offshore wind seems to be the obvious choice.

We also anticipate a dividend increase in the coming months related to the commissioning of Nordsee One. While most Canadian utility companies have been growing via acquisition, NPI has been concentrating its growth on greenfield projects, which have really been paying off.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.78	4.43%
Palos Equity Income Fund - RRSP	PAL 101	$6.41	3.78%
Palos Merchant Fund L.P. (Jun 30, 2017)	PAL 500	$4.22	5.65%
Palos WP Growth Fund - RRSP	PAL200	$9.92	-0.84%
S&P TSX Composite			3.10%
S&P 500			13.35%
S&P TSX Venture			52.59%

Chart 2: Market Data*

	Value
US Government 10-Year	2.27%
Canadian Government 10-Year	2.12%
Crude Oil Spot	US $50.71
Gold Spot	US $1,289.80
US Gov't10-Year/Moody BAA Corp. Spread	207 bps
USD/CAD Exchange Rate Spot	US $0.8110

* Period ending Sep 21, 2017

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■ What is New on the Macro Level?

By Hubert Marleau

On the Federal Reserve: What Is Next?

Barring demographics and productivity, monetary policy is the most important factor in determining the path of inflation and economic growth and the allocation and price of assets. This why the Federal Reserve is the most important economic institution in the U.S. The Fed, as it is commonly known, is basically autonomous and conducts monetary policy and oversees banks independently of government. Last Wednesday, without any government interference, the Fed decided to leave interest rates unchanged in a range of 1% to 1.25 % and begin the balance sheet runoff in October at a rate of $10 billion per month. The cap will increase $10 billion per quarter up to $50 billion a month. It reiterated that interest rates are likely to rise at a gradual pace with the possibility of one more increase in 2017 and three more hikes next year.

Yet, the Fed is not free to choose its board members. The U.S. president nominates board members with the approval of the Senate banking committee. Within a year, president Trump will have the opportunity to propose four new board members along with a new Chairperson and, in turn, could drastically change the operating philosophy of the central bank and dramatically alter the course of monetary policy. In terms of monetary policy, Trump is after the following:

- A conservative monetary approach that would do away with the liberal and flexible orthodoxies of the Phillips Curve, paying less attention to inflation and employment.
- A weak currency approach in the hopes of rectifying trade imbalances with countries that enjoy large trade surpluses with the U.S.
- A Monetary Policy that adopts set rules like the Taylor Rule or obeys a single and simple objective, like targeting a pre-set N-GDP growth. For example, adopt a 5% nominal growth rule.
- A supervision-lite philosophy that will fit neatly with his stated goal of deregulating the financial sector and rolling back 2010's Dodd-Frank legislation and lighten the post-subprime regulatory framework implemented by Obama.
- A board that will closely reflect the direction of his administration with the same end goals. That is 3% to 4% real growth rate.
- New blood at the Fed that will hold the Fed responsible for its actions.

Such changes would bring about a new focus, making the Fed more in tune with business and less with government. New metrics will be required to monitor the Fed if new rules are adopted to manage the monetary side of the economy. We will keep you posted on any major new developments.

Impact on the Bond Market

The immediate impact on the bond market should be neglectful because the Fed has spent months signaling its intention to shrink its balance sheet. It will initially allow only $6 billion of treasuries and $4 billion of mortgage-back securities to mature every month without reinvesting the principal. On the other hand, other foreign central banks are still actively buying bonds and less stimulus may decrease inflationary and growth expectations. Nevertheless, to the extent that the runoff of long-term assets steepens the yield curve, money market banks should generate better profits. What is more important is that these banks hold huge amounts of excess reserves totaling $2.2 trillion with the Fed. Given that the maturing assets held at the Fed will not be replaced, the associated liabilities will roll off, meaning that the excess reserves of JPMorgan Chase, Wells Fargo, Goldman Sachs, Citigroup, Morgan Stanley and Bank of America will fall off and will eventually need to be replaced with other assets that will pay better than the 1.25% that the Fed pays on "excess reserve" deposits. That could be a good profit boost for the money market banks. Canadian banks with operations in the US will also benefit.

Impact on Rotation of Assets

Stocks in the technology, healthcare, utilities and consumer staples sectors are starting to lag the cyclical sectors. Getting the rotation right is key to outperforming the benchmarks. In this connection, and given the confidence that the Fed has in growth, it may be a good time to rotate out of defensive positions and into reflationary sectors like financial, natural resources, material and industrial stocks. We are already positioned to take advantage of the potential reflation uptick.