Issue 39

PALOS INVESTMENT FUNDS

September 28, 2017

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Palos Weekly Commentary

■ Palos Funds

By Joany Pagé

Ethereum – Bitcoin 2.0

There has been a lot of hype lately about Bitcoin, blockchain and Ethereum. Despite their popularity, not a lot of people truly understand what they are. Let's start with Bitcoin. Bitcoin is simply a digital dollar. Anyone can buy and sell Bitcoin, and as such, it serves the same purpose as regular currency. It can be used to purchase goods and services and many online retailers now accept cryptocurrencies as payment. That is however where the similarities end. Thanks to the blockchain technology on which it is exchanged, Bitcoin is not held in a bank account and does not need to be administered by a third party. So, middlemen, such as banks, brokers and bookkeepers, are removed from the equation. Blockchain is essentially a decentralized record (or ledger) of all transactions. Everyone involved in the transactions has a copy of the record and it cannot be amended. The cryptography used in blockchain would automatically detect any alterations. This technology improves transparency, reduces costs and the potential for fraud. Another great advantage is that it is not held in one single location, but rather it exists in a digital realm, making it difficult to crash.

For the concept of blockchain to work, cryptocurrency miners are crucial. These miners are involved in releasing new cryptocurrencies, which is done by solving complex math equations. As more miners attempt to solve these problems, they become more complicated and require more computing power to solve. Once an equation is successfully solved, miners are rewarded with units of the cryptocurrency they are mining. Another important role of miners is to validate and process transactions which are then added to the blockchain. This also requires substantial computing power and can be completed within minutes. Miners are then rewarded for their service by way of transaction fees.

Blockchain is a technology not exclusive to Bitcoin. Its use can be much more far reaching. Ethereum is a platform designed to expand the capabilities of the Bitcoin blockchain. It was developed to use something called 'smart contracts.' These contracts are automatically executed on the platform when a transaction occurs. For example, if a customer signs up for internet services, the smart contract would

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.89	5.63%
Palos Equity Income Fund - RRSP	PAL 101	$6.48	4.82%
Palos Merchant Fund L.P. (Jun 30, 2017)	PAL 500	$4.22	5.65%
Palos WP Growth Fund - RRSP	PAL200	$10.05	0.5%
S&P TSX Composite			4.33%
S&P 500			13.82%
S&P TSX Venture			52.70%

Chart 2: Market Data*

	Value
US Government 10-Year	2.31%
Canadian Government 10-Year	2.13%
Crude Oil Spot	US $51.59
Gold Spot	US $1,285.90
US Gov't10-Year/Moody BAA Corp. Spread	206 bps
USD/CAD Exchange Rate Spot	US $0.8044

* Period ending Sep 28, 2017

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retrieve the payment and provide the internet service in a completely automated fashion. These contracts are still in their early stages, but as they evolve, their applications will become virtually limitless and whole organizations could possibly be built using this technology. Ethereum is definitely something to keep an eye on as it has the potential to revolutionize how businesses operate.

■ What is New on the Macro Level?

By Hubert Marleau

What Is Going on With Inflation?

Not only is inflation stuck below the 2% target of most central banks, it is dropping in many countries. Yet, we have been in a global expansion for eight years and the unemployment rate is very low. Neither hourly wage rates, unit labor cost or commodity prices are under any serious upward pressure. It should be well noted that persistent inflation is a modern phenomenon. Historically, bursts of inflation were associated with wars or natural disasters, that either destroyed supplies and/or were financed by currency debasements. Persistent inflationary conditions started in the 1960's and stopped in the early 2000's. One can make a reasonable argument that aging populations, combined with far reaching development in technology, widespread globalization, decades of financialization, anchored anti-inflation credibility and global glut of savings, are the main drivers for they immensely transform the way the world works. The abruptness of these key economic changes has brought about political consequences, demanding government interference in the independent nature of central banking. The malcontents are expressing their feeling at the ballot box. The big question is whether this inflationary dryness will cease soon. My quick answer is no. However, cyclical price movements will continue, but they are likely to be short and shallow. Thus, I do not believe, given our reasoning, that a secular shift towards higher rates of inflation is under way. However, we are not altogether against those who do not adhere to our kind of thinking for cycles will continue to exist.

Claudio Borio, head of the BIS Monetary and Economic Department, thinks it is conceivable that the globalization of product, capital and labor markets has weakened the traditional link between employment and inflation. He said, "It is reasonable to believe that the inflation process should have remained immune to the entry into the global economy of the former Soviet bloc and China, and to the opening of other emerging countries and to the technological advances, that allowed the relocation of the production of goods and services across the world". This whole business added 1.6 billion people to the effective labor force. More specifically, he wrote: "one can think of two types of effects of globalization on inflation. The first is symmetrical: assuming akin to a global Phillips curve, one would expect domestic slack to be an insufficient measure of inflationary or disinflationary pressures; global slack would matter too. The second is asymmetrical: one would expect the entry of lower-cost producers and old, cheaper labor into the global economy, to have put persistent downward pressure on inflation, especially in advanced economies and at least until costs converge." It makes good sense that the role played by the global value chains has grown substantially since the 1990's. This has, in turn, created a very important transmission channel of global influences on domestic inflation, notably by increasing competition at all stages of production and by decreasing domestic labor pricing power. Additionally, it would not be hard to imagine that technological advancements in robotics, shopping, search machines and internet applications could have also threatened the pricing power of labor to the benefit of firms.

What Is the Implication of Persistently Low Inflation On Monetary Policy?

If the assumption that low inflation is here to stay, then either the estimated natural rate of interest rate is much lower than believed and/or the potential level of economic activity is much higher than the current calculations. Acknowledging that demographics growth is out of the question, the productivity puzzle has an answer. The fact of the matter is that technology had a considerably larger effect on reducing inflation than increasing output. If this latter phenomenon was to change, one could make a decent argument that interest rates could end up where the Fed would like to see them. Much higher that is. Many of our readers have asked me why technology has not shown up in the productivity numbers. I answer that we don't realize that the internet has eliminated the middleman in just about everything. Today, I shop, bank, book travel plans, entertain myself, read books and news, order groceries, make reservations, communicate etc. on my mobile, tablet or computer. There are human actions that don't involve monetary transactions and are, therefore, partially free. For example, if I make a

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table for myself, I don't charge my time, but if I buy one from a store, someone is charging for the time spent making one. Indeed, disinflationary pressures stemming from globalization and technology should be considered benign, for they are the product of favorable supply side effects. In other words, inflation is weak not because of a lack of demand. History is conclusive that interest rates fall as debt rises. Thus, the health of the financial system is what needs to be observed. Unless one believes a vast amount of capital will find its way into non-profitable investments and/or wasted on obsolete projects instead of heading, as it has for the last 20 years, into globalization and technology, there should be little doubt that we are going to get more of the same; Which is low inflation. In this cycle, the most important question is at what rate level does the Fed kill the economic expansion and the bull run. Based on what the Fed thinks is the neutral Federal Funds rate, the number is around 2.75%. But, based on market interpretations of the current economic data and the above hypothesis, we suggest that without an uptick in productivity growth, the neutral rate of interest is probably not any higher than 2.00%; meaning that only three more rate hikes, at best, are in view. Moreover, common sense tells us that balance sheet reductions should make the neutral rate lower than the one dictated by regular theory. If our way of thinking is correct, yields on ten-year treasury notes may not get any higher than 3.00% for this cycle. Additionally, there is sufficient evidence to believe that the U.S. may have reached full employment.

For example:

- the Underlying Inflation Gauge (UIG), a product of the New York Fed, which captures a broad set of prices, real activity and financial data, shows that consumer inflation is firming and rising and that the Fed’s 2.0% target has been met,
- hourly wages are racking up solid gains better than pre-crisis era, if inflation is taken into consideration,
- Demographic conditions are having a dragging effect on wages, as costlier baby boomers are replaced by cheaper young workers,
- Federal Reserve Chairwoman admitted that if low inflation persists, a slower pace of rate rises should be expected.

  In this connection, it may make sense that further rate hikes will be more about smoothing out financial risks rather than bucking economic growth. In other words, there is no reason for the Fed to apologize as its mandate of stable inflation and economic growth has been achieved, and this why we think that the Fed may revise expectations downward and recalibrate rate hikes.

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