Issue 43

PALOS INVESTMENT FUNDS

October 26, 2017

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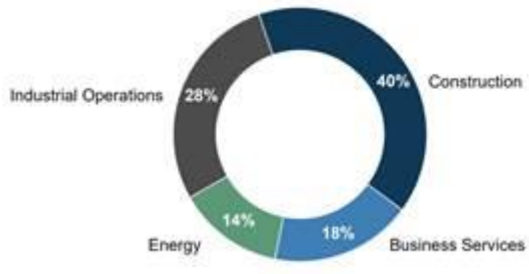
Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

A Hidden Diamond in Brookfield Business Partners

Brookfield Business Partners LP (TSX: BBU.U) is invested in four different industries.



Palos' interest lies under the industrial operations, where BBU.U has an investment in a company called GrafTech (GFT). The company is vertically integrated. First, they produce petroleum needle coke via its fully owned subsidiary. Second, they use the coke to make synthetic graphite. GFT sells the majority if its synthetic graphite to the steel business via graphite electrodes.

The price of synthetic graphite has been moving significantly higher in recent month. Macroeconomic and industry specific conditions have created significant unbalance between demand and supply for synthetic graphite. One reason is that the Chinese manufacturing facilities have decreased their synthetic graphite production in China because of environmental restrictions. The increase in demand is primarily coming from steel. The world steel association forecasts that global steel demand will increase to 1,622 million tons in 2017 and 1,648 tons in 2018. However, the elephant in the room is the electric car revolution. Lithium ION batteries prefers to use natural flake graphite to synthetic because of environmental impact and cost. However, there is only so much natural graphite flakes. There may be some disadvantages with synthetic, but also has some advantages namely that synthetic has less variations in quality. Consequently, Panasonic uses both synthetic graphite and natural graphite in their battery production.

Currently, GFT does not supply any synthetic graphite to battery manufacturers. However, the price is not driven by who buys the end product, but by supply and demand and Palos believes synthetic graphite is in shortage and price will continue to rise.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.88	7.68%
Palos Equity Income Fund - RRSP	PAL 101	$6.51	7.06%
Palos Merchant Fund L.P. (Sep 29, 2017)	PAL 500	$4.21	5.36%
Palos WP Growth Fund - RRSP	PAL200	$10.42	4.25%
S&P TSX Composite			6.34%
S&P 500			16.22%
S&P TSX Venture			54.05%

Chart 2: Market Data*

	Value
US Government 10-Year	2.46%
Canadian Government 10-Year	2.03%
Crude Oil Spot	US $52.73
Gold Spot	US $1,266.30
US Gov't10-Year/Moody BAA Corp. Spread	194 bps
USD/CAD Exchange Rate Spot	US $0.7784

* Period ending Oct 26, 2017

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In the first 9 months of 2017, GFT was pricing their graphite rods, also known as graphite electrodes, at $2,500 a ton. Although prices have risen in the past year, GrafTech has been unable to take advantage of this development as pricing is negotiated in Q4 of the preceding year. Management and analysts have stated that they are expecting north of $7,500 a ton for graphite in 2018 with final pricing currently being negotiated. On an annual basis, each $500 per ton increase should increase the EBITDA of BUU.U by $27 million.

■ What is New on the Macro Level?

By Hubert Marleau

On the Canadian Dollar: The Bank of Canada is keeping interest rates on hold warning that neither exports or prices are showing sufficient increases to support any changes in the Canadian monetary stance.

The Canadian Dollar was exchanging hands on Thursday for $0.7780, close to our estimated purchasing power parity rate. Assuming that the monetary policy path of the Bank of Canada will follow that of the Federal Reserve Bank, in a parallel fashion with a short delay and that the Canadian terms of trade do not materially change from where they are now, interest rate differentials between Canada and the U.S. should widen in favour of the Greenback and bring about some more downward pressure on the Loonie. While the Central Bank acknowledges that rates are likely to rise over time, it nevertheless revealed that it will be cautious in making future adjustments to the policy rate. The monetary authorities are of the opinion that the Canadian dollar appreciated more than they would like. Moreover, it is important to note the following points that could bring additional pressure on the exchange value of the Canadian Dollar. It is not unusual for the Loonie to trade below its purchasing power rate until imbalances are corrected.

Firstly, the pace of the Canadian economy is slowing from the exaggerated pace that we witnessed during the first half of the year. Retail sales decreased 0.3% in September indicating that Canadian households are starting to feel the burden of their over-debted situation. Raising rates too fast and too high could abruptly hurt consumer sentiment. Household debt is about $2.0 trillion or about 100% of N-GDP.

Secondly, core consumer prices are not rising and they are far away from the 2.0% target that the Bank of Canada has set as an intermediate objective. Core prices are up only 0.8% from last year and headline inflation is only 1.6% year over year. Assuming that the pace of economic activity in Canada and the U.S. will be similar from hereon, and given that the inflation rate is 0.6% lower than it currently is in the U.S., interest rate differentials along the yield curve should be around 60 bps. Presently, the spreads are on average about 30 bps in favour of the U.S. Bottom line, interest rates should be lower in Canada than in the U.S.. A good reason why the Bank of Canada decided to pause after two consecutive rate hikes.

Thirdly, economists surveyed by Bloomberg Canada believe that the potential output of the Canadian economy may be much higher than what the Bank of Canada assumed last July. They argued that potential growth is more like 1.7% between 2017 and 2019 compared to the Bank of Canada's 1.4% July forecast. Canada's economy may have more slack than commonly believe, suggesting that the economy could be stimulated in an non-inflationary manner. As a matter of fact, on Thursday, the Bank of Canada increased the potential growth estimate to 1.5%.

Fourthly, the notable shift to protectionism is a major source of uncertainty. About 75% of Canadian exports goes to the U.S. and NAFTA is in jeopardy. A dismantling of NAFTA, according to several estimates, would cost Canada at least 1.0% in growth per year over the next 10 years.
In this latter connection, Canadian economic growth can be classified as fragile and only two things could hold it up should NAFTA take a bad turn. These are much higher oil prices and/or implementation of large infrastructure projects like pipelines. Insofar as the oil price is concerned, there is not much hope for it to be above the marginal cost of $55 a barrel in sustainable way.

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