

November 9, 2017

To subscribe to our Newsletters
www.palos.ca/register

■ 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

Disclaimer: No part of this publication or its contents may be copied, downloaded, stored in a retrieval system, further transmitted, or otherwise reproduced, disseminated, transferred, in any form or by any means. This publication is proprietary to Palos Management Inc. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. The information contained herein is not necessarily complete and its accuracy is not guaranteed by Palos Management Inc. The information provided in this material does not constitute investment advice and it should not be relied on as such. If you have received this communication in error, please notify us immediately by electronic mail or telephone. The overall views expressed in this report are prepared by Palos Management Inc. This document may contain certain forward-looking statements that are not guarantees of future performance and future results that could be materially different from those mentioned. Past performance is not a guarantee of future performance. "S&P" is a registered trademark of Standard and Poor's Financial Services LLC. "TSX" is a registered trademark of TSX Inc. The Bloomberg USD High Yield Corporate Bond Index is a rules-based, market-value weighted index engineered to measure publicly issued non-investment grade USD fixed-rate, taxable, corporate bonds. To be included in the index a security must have a minimum par amount of 250MM.



Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Tourmaline is Changing Gear

For many years, Tourmaline Oil Corp (TSX:TOU) has been known as one of the fastest growing oil & gas companies in Canada. TOU has grown its production to 265 MBOE/d, which makes it one of the largest gas producers in Canada. For long, Investors favored TOU's growth strategy and acquired the stock at a premium relative to its peers. The company was able to spend more than its cashflow and used capital markets to fund that growth. This is, however, only possible when the equity keeps trading at a healthy premium. Our government's lack of vision on LNG export terminals, the Trans Canada Pipeline issues, and US competition, have changed the industry's landscape. The premium on growth names has slowly vanished and contenders, such as TOU, have started trading at a discount to their peers. Realizing that they had to adapt, TOU changed their strategy to moderate growth. Palos believes that in this natural gas price environment, slowing growth to 5-10% versus 10-15% is the prudent thing to do. TOU has cut its capex program from \$1.5bn to \$1.08bn. This has allowed TOU to initiate a dividend of \$0.32/share

annually. This represents \$86 mil, which can mostly be funded by third-party revenue from the company's midstream assets.

In conclusion, TOU is the largest pure natural gas play in Canada and has a very attractive evaluation. Tourmaline now pays a dividend and will continue to grow between 5 and 10%. If natural gas prices strengthen, TOU will pay down its debt and reconsider growth. Meanwhile, the company has realized that growing for the sake of growing is not a sustainable plan. Palos is supportive of management on this new and prudent strategy.

■ What is New on the Macro Level?

By Hubert Marleau

The Federal Reserve in the Image of Trump

The appointment of Jay Powell has gone down as a non-event because it looks like a sane choice that spells more continuity. It's a safe gamble. If Trump had nominated John Taylor or Kevin Warsh, it would have been a clear-cut change. During his tenure, Powell never dissented from the Fed's monetary policy decisions in both the gradual approach to normalizing interest rates and the slow plan to reduce the FED's balance sheet.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	\$10.10	10.13%
Palos Equity Income Fund - RRSP	PAL 101	\$6.64	9.19%
Palos Merchant Fund L.P. (Sep 29, 2017)	PAL 500	\$4.21	5.36%
Palos WP Growth Fund - RRSP	PAL200	\$10.51	5.08%
S&P TSX Composite			7.68%
S&P 500			17.40%
S&P TSX Venture			56.10%

Chart 2: Market Data*

	Value
US Government 10-Year	2.34%
Canadian Government 10-Year	1.93%
Crude Oil Spot	US \$57.17
Gold Spot	US \$1,286.50
US Gov't10-Year/Moody BAA Corp. Spread	191 bps
USD/CAD Exchange Rate Spot	US \$0.7885

* Period ending Nov 9, 2017

November 9, 2017

To subscribe to our Newsletters
www.palos.ca/register

■ 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

Interestingly, Powell has broad support from both those who were behind the QE policies of Yellen-Bernanke and from those who were strong critics of QE. He appears to have same desire to get interest rates near the presumed unobtrusive neutral level of 3%. He has a deep understanding of banking regulation and market liquidity as he comes with substantial experience as a member of the Federal Reserve Board of Governors. He backs the regulatory framework put in place under the Obama presidency, albeit with less strict implementation. Mr. Powell made his career and his wealth on Wall Street and perhaps may be lenient with the big banks. In some way, being as wealthy as he is may make him independent of politics without a preset agenda. In the past, Powell has worked at a bipartisan think tank. He is known for his executive style that relies a lot on instinct and improvisation. Roughly 88% of respondents to a WSJ survey of Fed Watchers said that Powell would pursue the same monetary stance as under Janet Yellen.

Despite the apparent similarities in style, in my judgement, Powell's tenure could easily turn out to be very different than popular expectations. The independence of the federal reserve might be considered a cornerstone of its identity, crucial for keeping monetary policy decisions free of electoral politics, but this common wisdom is inaccurate. In this regard, the optics of Jerome Powell do not sit well with the President's political base. While the Fed clearly wants price stability to reign, unemployment to stay low, and economic activity to hum, policy mistakes can arise. It is not easy for the Fed to get it right. There is a challenge to bridge the divide between the Fed and the financial markets on where interest rates are headed. Indeed, the bond markets seems overly pessimistic compared to the Fed about when the current cycle of tightening will end. It should be noted that Mr. Powell is not a trained economist. That is not a problem, but it means that he may have to rely on a fresh slate of new central bankers next year that may be more rigid than he is when it comes to policy decisions, and more lenient when it comes to banking regulations. In addition to the departure of New York Fed President William Dudley, Vice Chairman Stanley Fischer, and Fed chair Janet Yellen, Trump has three other seats to fill on the Fed's powerful Board of Governors, giving the White House an unusually wide window to reshape the central bank and remake the policy-decision team. There are seven members on the board and the president will end up with 4 nominees.

Last month, Trump nominated Randal Quarles to the board of governors. He's the Vice-Chair for Supervision. Last Tuesday, he said that all the agency's Wall Street rules should get a fresh look and that Annual Bank Stress Tests are "on the front burner". The scuttlebutt is that financial regulations will rely less on proactive rule-making and therefore be less strict. Conservatives favour lighter and simpler rules combined with a focus on the capital that banks use to support lending. It makes good sense. Making financial firms stronger with additional capital may be the best way to avoid future crises with less intrusive oversight.

The incoming Chair of the Fed is not a trained economist and his lack of academic weight may force him to rely on a board of conservative economists who are usually more rule oriented. It should be noted that a rule like the one proposed by John Taylor is fully consistent with the statutory dual mandate of the Fed to stabilize prices and maximize employment. The numbers show that the Federal Funds rate should presently be 2.00% and that they should move to near 3.00% when year-over-year core PCE inflation rate reaches 2.0%.

P.S. History shows that growth in N-GDP is a key driver of long term interest rates. It also explains where interest levels should be at any given time. For example, if the growth of N-GDP is sustainable at the annual rate of 4.00%, there are better than even odds that yields for ten-year U.S. bonds should trade for about 75% of that nominal growth, at 3.00%. Unfortunately, the formula is not perfect as interest rates can vary widely to either side of that guideline. This occurs when monetary policy bucks the equation. Under easy money, the nominal rates tend to be lower than where they ought to be and higher when money is tight. In this connection, it is crucial to monitor the current and expected path of the economy in nominal terms and the present and anticipated monetary stance of the Fed. It is imperative for professional investors to try to get this right to get some alpha out of their portfolio without incurring more risk than the benchmark. To be continued...

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