PALOS
INVESTMENT FUNDS

November 16, 2017

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

In a Class of its Own

InterRent Real Estate Trust (TSX: IIP-U) really hit it out of the park this last quarter. I have written about this multi-family REIT many time in the past. InterRent reported 16% growth in funds from operations (FFO) versus Q3 of last year. IIP-U also achieved 11.2% net operating income (NOI) growth. Its peers are nowhere close to IIP-U and Palos continues to see NOI growth through 2018. The LIV Apartment project has been an incredible success for IIP-U. Please visit www.livottawa.com to get a taste of what they created. In addition to its positive momentum, IIP-U increased its distribution by 11%, the sixth consecutive annual dividend increase. IIP-U is one of the few REITS that can deliver this kind of significant growth. The REIT and its partners are working on new developments that will also translate to more growth. Palos has taken positions in three other REIT's or real estate companies that we have identified as also providing growth opportunities. These companies are Tricon Capital Group (TSX:TCN), Stauragevault Canada Inc (TSX:SVI), and Sienna Senior Living Inc. (TSX:SIA) . In an environment where interest rates are volatile, being protected by growth is the prudent way to invest in real estate.

■ What is New on the Macro Level?

By Hubert Marleau

The Forecasting Plan:

Investors who wish to be profitable must try to make forecasting easy. Decluttering the mass of data is essential, otherwise one would do better by getting out of the money management business. Whether one likes it or not, investors should have a few reliable rules that weather various economic regimes, since as mere mortals we are not particularly good at forecasting future economic conditions and/or assess the probability of economic outcomes. A simple working plan is good way to tackle this problem. When it comes to the stock market, we know that interest rates, corporate profits and sentiment are the three primary factors that define valuations. While it is true that from to time external shocks such as a sudden change in oil prices, geopolitical instability, or even political curveballs can upset us, we find that sticking with the game plan is best.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$10.05	9.59%
Palos Equity Income Fund - RRSP	PAL 101	$6.59	8.33%
Palos Merchant Fund L.P. (Sep 29, 2017)	PAL 500	$4.21	5.36%
Palos WP Growth Fund - RRSP	PAL200	$10.37	3.67%
S&P TSX Composite			6.76%
S&P 500			17.57%
S&P TSX Venture			55.92%

Chart 2: Market Data*

	Value
US Government 10-Year	2.38%
Canadian Government 10-Year	1.97%
Crude Oil Spot	US $55.14
Gold Spot	US $1,278.30
US Gov't10-Year/Moody BAA Corp. Spread	196 bps
USD/CAD Exchange Rate Spot	US $0.7839

* Period ending Nov 16, 2017

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The Long-Term Interest Rate:

History undeniably shows that in the fullness of time, the path followed by long term interest rates is a function of the Gross Domestic Product expressed in current dollars (NGDP). Blackrock recently reported that the level of NGDP growth is key to understanding the level of long term interest rates. Looking back at the past 60 years, a smoothed average of nominal growth explains about 60% of the variation in long term rates. Palos has been aware of this dependence for a long time and found that the correlation can indicate where interest levels should be at any given time. Consequently, it is imperative to clarify what constitutes NGDP. In physical terms, NGDP is the product of employment, productivity and inflation. Specifically, the faster these later components increase, the faster NGDP grows and, in turn, determines what the level of long term interest rates should be. Presently, this combination is producing nominal growth of 4.10%. In the year ended September 2017, employment growth rose 1.4%, productivity gains totaled 0.9% and inflation increased 1.8%. As a rule, ten-year Treasury yields equate to 75% of NGDP growth. Based on this formula, long rates should be near 3.00%. The formula is not perfect. In fact, interest rates can vary widely to either side of this parameter. To understand the cause of this occurrence, it important to look at the monetary side of the economy. It's axiomatic that the level of economic activity in current dollar is a function of the money supply and its turnover. For the period under review, the transactional money supply with zero maturity (MZM) increased 4.4% while its velocity decreased 0.3% to produce a 4.1% increase in NGDP. This where the Fed comes in. Contrary to conventional wisdom, the Fed does not print money. In fact, it has no legal authority to do so. This is a fundamental misunderstanding. The Fed tries to influence the decisions of bankers by manipulating the amount of bank reserves by buying from or selling to them financial assets and by varying the rate on federal funds. Thus, banks will make loans to customers if they have excess reserves and if they believe it to be profitable. In other words, reserves that are held by banking institutions only become money accessible to the general population after a bank decides to loan out the reserves. Under easy money, the federal funds rate tends to be lower than where it should be and/or banks reserves larger than where they need to be. Under tight money, the federal funds rate tends to be higher than where it should be and/or bank reserves smaller than they need to be. Since the Great Recession, the Fed's monetary stance has been very easy because the banking system has been blessed with excess reserves resulting from Quantitative Easing (QE) as well as extraordinarily low interest rates. Presently, the banking system has excess reserves of $2.350 trillion and the federal funds rate is 1.00%, substantially less than the current 2.0 % rate of inflation and the Taylor-Equilibrium value of 1.75%, and 1.40% below ten-year Treasury yield of 2.40%. Consequently, it explains why long-term interest like yields on ten-year treasuries are about 60 bps lower than the 3.00% that our NGDP formula indicates.

The Outlook for Long Term Interest Rates:

The Fed started a normalization process to move monetary policy towards an even keeled position. The monetary authorities have increased the federal funds rate four times in the last two years to 1.125% and have started to reduce excess banking reserves by as much as $350 billion since the end of 2015. We are of the opinion that the normalization process will continue for as long as high frequency economic models track economic growth, the pace of inflation continues to rise, the recession risk remains moderately low and financial indicators don't show banking and market stresses. For the moment, the economy looks good:

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1. The Atlanta Fed's GDPNOW and Moody's Analytics' real time high frequency models suggest GDP is on track to grow by an annualized 3.0 % or greater in the fourth quarter.

2. The NY Fed's Underlying Inflation Gauge (UIG) is one of the better price-component indicator of near term inflation prospects. This gauge has been rising since April 2015 and rose 2.3% year-over year in September. It's notable that the PCE Price Index tends to lag but follow the UIG. Producer prices, a gauge of U.S. business prices, printed a surprising year over year increase of 2.8% on Tuesday. These business prices generally follow the same trends as other major inflation indices.

3. Moody's Analytics gives only a 5% chance that the U.S. economy could be in a recession in the next six months while the WSJ gives a probability of 12% that a recession is a possibility over the next twelve months.

4. According to a variety of financial stress indices produced by the St-Louis Fed, the NY Fed and Goldman Sachs, there are hardly any strains on either the banking system, the money markets or forex markets.

5. Societe Generale came out with an interesting note on employment a few days ago. The note to their client argued that the pool of potential workers is shrinking fast. The pool of available workers refers to the total number of unemployed workers plus all those who are not in the labour force but who are searching for a job. This pool is shrinking fast and represents only 5.4% of what is left. This pool was 7.0% during the 1994-2007 period. Société General calculates that the pool of available workers is down 700K in the last three months, 1.1 million in the last six months and 1.9 million in the last 12 months. Hourly wage rates are rising at an annual rate of 2.5% and are likely to keep on increasing.

After a decade of flooding the banks with reserves and low borrowing cost, the Fed will clearly turn off the tap. The Fed stopped replacing some maturing bonds in October and has effectively put the process of shrinking its balance sheet on autopilot. The rundown is assets accelerating in stages; $50 billion a month in bonds will be taken out by October of next year. The transformation from easy money to even keel money will be the pivotal event of 2018. Despite this change, we do not subscribe to the thesis that the Fed will embark on a new tight money era. For now, we see long term rates rising to 3.00% and the federal funds rate increasing to 1.875%. We do not believe that rates are going any higher. Debt levels are relatively high, and it will not take much of an increase in interest rates to sap disposable income. Moreover, personal saving rates are relatively low. Accordingly, consumer spending, the main driver of economic activity, could slow down a lot if the Fed is not careful. Retail sales were very soft in October.

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