Issue 47

PALOS
INVESTMENT FUNDS

November 23, 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

Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Tax Selling Brings Black Friday Sales

The worst performing sector in 2017 is officially energy. Every segment in the sector is underperforming the broader market. The stock performance of the majority of all midstream, services, or producer companies has been negative. Most sectors in Canada and in the U.S. have achieved positive performance numbers this year. It is fair to assume that many investors realized significant capital gains in those sectors during the year. As November tax planning takes priority over fundamentals, this brings further selling to an already oversold energy sector. Investment opportunities arise as quality energy names are trading at historical discounts. Included are a graph and a table showing the disconnect between the Canadian energy ETF and crude oil.

The table shows the actual average multiples of each subsector compared to their 5 and 10 years average.

	2018e Sector Avg.	5 Year Avg.	10 Year Avg.
Exploration & Production	**EV/DACF**		
Large Cap	7.5x	8.2x	8.2x
Mid Cap	6.5x	8.0x	8.3x
Small Cap	5.6x	7.7x	7.7x
Energy Services	**EV/EBITDA**		
Drillers	7.0x	7.0x	6.2x
Frackers	5.3x	13.1x	9.9x
Fluid Management	8.7x	10.8x	9.0x
Midstream	**P/AFFO**		
Midstream	11.9x	12.1x	11.1x

As tax selling abates, which usually happens at the end of November or early December, I think investors will seek opportunities in value energy names. Palos believes energy has great value and is due for a rally. Aside from the fundamentals, the energy sector has a few positive themes that make the sector a very compelling investment. For example, oil prices are hitting 52-week highs ($58.37 USD or $74.23 CAD) and gasoline and oil demand is very healthy. This is particularly noteworthy when you consider that we are in shoulder season, where a significant reduction in demand is usually observed as the transition from the driving to heating season occurs. Lastly, the

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$10.12	10.26%
Palos Equity Income Fund - RRSP	PAL 101	$6.64	9.10%
Palos Merchant Fund L.P. (Sep 29, 2017)	PAL 500	$4.21	5.36%
Palos WP Growth Fund - RRSP	PAL200	$10.43	4.30%
S&P TSX Composite			7.74%
S&P 500			18.11%
S&P TSX Venture			56.00%

Chart 2: Market Data*

	Value
US Government 10-Year	2.32%
Canadian Government 10-Year	1.89%
Crude Oil Spot	US $58.56
Gold Spot	US $1,290.70
US Gov't10-Year/Moody BAA Corp. Spread	192 bps
USD/CAD Exchange Rate Spot	US $0.7864

* Period ending Nov 23, 2017

PALOS
INVESTMENT FUNDS

November 23, 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

Canadian energy sector seems to be downplaying the Keystone XL (KXL) news. KXL alone will support approximately 400,000 bpd of oil sands production growth in the next decade. This will indirectly increase the demand for condensate between 125,000 to 150,000 bpd, which would be positive for condensate pricing relative to WTI and positive for midstream and service companies and condensate producers in the Montney/Duvernay region.

Palos does not anticipate multiples moving back to their historical highs as market perception of energy has changed with the electric car revolution. However, Palos believes the perception has brought multiples to a very intriguing level, and tax selling has added gasoline to the fire.

In this type of scenario, you don't need to be a hero. You can simply stick with high quality companies that have proven management teams. Palos' favorites names are:

Exploration & Production:
- Whitecap Resources Inc (TSX:WCP)
- Enerplus Corp (TSX:ERF)
- Tourmaline Oil Corp (TSX:TOU)
- Arc Resources (TSX:ARX)

Energy Services:
- CES Energy Solutions Corp (TSX :CEU)
- Secure Energy Services (TSX :SES)

Midstream:
- Keyera Corp (TSX:KEY)
- Tidewater Midstream (TSX:TWM)

A special thanks to the Oil & Gas, Services, and Midstream team at National Bank.

■ What is New on the Macro Level?

By Hubert Marleau

On Productivity: It's Important to Get a Handle on This

What is productivity? I found the best definition of productivity in a speed reading book written by Nathan Armstrong. "It simply means getting as many things done as best as they can be done and as quickly as they can be done." In fact, given two activities or processes of equal quality, the one that's faster wins the competition hands down.

An uptick in this endogenous factor would protect stock market valuations, and more importantly, increase potential growth, enhance the probability of a successful normalization of monetary policy, boost economic activity, heal the debt burden and reduced income inequality. Demographic forces are not favorable for future real growth as the pool of available workers is shrinking fast and, in turn, a reduction in the annual rate of change in employment over the coming years is expected. R-GDP cannot rely on employment for much more than 0.5% per year over the next 10 years. If monetary authorities are able to keep the annual inflation rate in check around 2.0%, the future of growth is therefore dependent on productivity.

Not much is said about productivity because few understand anything about it. Most strategists and economists waste too much time on business and credit cycles. The reality is, future economic activity is entirely dependent on what productivity will do in the future. Almost 50% of my reading time is spent on this issue. The official productivity data, defined as the output per hour worked in the non-farm sector, has been in a persistent slowdown since 2004. The decline has taken the last 25 quarters annualized growth rate down from a long-term trend of 2% to 0.9%. Productivity gains reached their lowest point in the quarter ended March 2016 declining 0.3%. This decreased persisted in the following two quarters. What is interesting is that productivity took a turn for the better in 2017 suggesting that technology and business capital formation may have started to have a larger impact on raising output than on decreasing inflation. Unfortunately, this topic is complex and anecdotal creating uncertainty about where productivity is heading. The problem is that productivity data is subject to wild, random and large variations making extrapolations unjustifiable. Nevertheless, Palos has written several comments on the subject and we are on record as saying that when improving IT is combined with business

PALOS
INVESTMENT FUNDS

November 23, 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

fixed investment, particularly on intellectual property products, there is a tendency for productivity to rise when diffusion takes place. We are of the opinion that we are at the beginning of a new economic regime that will boost productivity gains back to their original 2.0% growth factor.

The outlook for productivity has three main views:

1. The pessimistic case is based on two assertions. One, is that great technological breakthroughs are unlikely to be repeated. The second, is that marginal productivity of researchers is inexorably falling. A captivating new paper from Stanford University (Nicholas Bloom) and MIT (Isabella Kaminska) claims that more researchers are needed to maintain a given rate of growth in productivity in any given field. The Stanford paper shows how R&D has changed to generate the improvement of computer processors in line with Moore's Law. "In order to double the number of transistors packed into a CPU every two years, thus maintaining the exponential growth rate of computing speed at 35% per year, the required research input has increased 18 fold over three decades. An alternative way of expressing this point is that the productivity of R&D in this area has decreased at the annual rate of 6.8% since 1971, or a factor of 18 times since that date". There are other areas that have exhibited negative growth in productivity such as crop yields or cancer treatment. I'm not surprise that the above pattern is omnipresent as it is the norm in economics when other factors are kept constant. Diminishing marginal return is an undeniable economic force. This group of thinkers are betting that Total Factor Productivity (TFP) will average only 0.4% per year over the next decade.

2. Fortunately, other factors are not always constant. Diminishing returns do not apply in all fields of endeavour and across the economy as a whole. Firstly, digitization levels are only high in a few areas such as finance, computer systems and software development. The impact of digitalization is only beginning to be felt in numerous occupations such as lawyers, automotive services, registered nurses, office clerks, security guards, restaurants, construction workers and personal care aides. Secondly, significant improvements in the science of materials, electric motors and computing spin-offs like blockchain, artificial intelligence, robotics, business trading, 3-D imaging, web-application and internet-sales are being registered. Thirdly, billions of dollars are being spent ($3.0 billions in 2017) on intelligent and robotic warehouses; that is three times as much as the average spend in the period between 2010-2016. Fourthly, global sales of industrial robots are growing at an annual rate of 20%. Up to now, most robots have been sold in the electronics and automotive sectors. Lately, other industries such as metals, food, and chemicals have shown interest in this newer technology. A new report from The Federation of Robotics shows that a new trend in collaborative robots and cobots, specifically designed to work alongside humans, is accelerating. Meanwhile, business investments, in real terms, grew at the annual rate of 6.0%, almost 2.5 times faster than the GDP in the first nine months of 2017. This group of thinkers believes that a large economic impact is just around the corner and they are betting on a 2.0% growth factor. If R-GDP increases at the annual rate of 3.4% in the fourth quarter without much help from employment, this group might be right that we are in fact be on an accelerating productivity path.

3. Interestingly, the Congressional Budget Office (CBO), nonpartisan government agency, provides a halfway forecast between these two extremes at 1.1% per year.

We cannot help but think optimistically given the great excitement about the digital economy. In our view, the coexistence of weak productivity performance and rapid technological change will become less of a puzzle when capital accumulation in technology shows that it is the fundamental building block for projecting economic growth. In this regard, Palos management has taken some long term strategic positions in the productivity sector without giving up our sources of liquidity as protection against business cycles.

There are defining moments for portfolio management. For example, 1964 launched the inflation era and the commodity boom. 1982 introduced tight money and declining inflation. 1994 introduced the dot.com era. 2008 introduced the experimental period of easy monetary policy. Investors who ignore defining moments are unable to manage money effectively. I think that 2017 may be one of those defining years. By 2020,

PALOS
INVESTMENT FUNDS

November 23, 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

we should have a perfect vision as to whether the technological advancements will prove out our productivity thesis. The low cost of money and quantitative easing lifted all boats and ETF's fared well during the 2009-2017 period. But, should productivity turn out to be what we think it could be, investors may be better off to leave the black box and return to traditional analysis and interviews. Sitting across the table to have conversations with the entrepreneurs who make things happen may seem old fashioned, but it's the only way to know who is inventing capital efficiently. This kind of research can be costly, but it can lead to great rewards in the ensuing productivity era change. Profitability will not belong to all companies like it was in the last era but to those who are willing to invest capital, time and effort to improve efficiencies.

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