PALOS
INVESTMENT FUNDS

November 30, 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

Liquor Stores Getting Back on Track

Liquor Stores (TSX:LIG) went public as an income trust in 2004 and quickly became a market darling. The company used its lofty valuation to make acquisitions and quickly became one of the largest liquor store operators in Western Canada. The opportunities quickly dried up in Canada, and the company went to the United States to seek greener pastures. The lack of discipline quickly got the company into trouble. LIQ's payout ratio, debt level, and inventory management got out of control and became a serious drag to the company.

A white knight has come to rescue. PointeNorth Capital (PNC) out of Toronto has taken a 9.9% position in the company and has taken control of the board. PNC outlined a new strategy whereby the company is focusing on its balance sheet, operations efficiency, inventory, and margin.
LIQ has already implemented some important measures. It sold its Kentucky stores and is now finalizing the sale of its New Jersey locations. The Kentucky assets alone had a significant impact on the balance sheet and profit margins. Secondly, the company is continuing to sell its excess inventory, and is implementing an ERP system that will better manage inventory in the future. Palos is pleased with the progress and continues to see LIQ as an investment opportunity. Once the balance sheet and inventory issues are solved, the company will be able to focus, on its brand and reinvigorate its stores that have been neglected for years.

LIQ also has a significant opportunity on the horizon. The government of Alberta recently announced that cannabis is most likely going to be distributed via private retail stores. LIQ's experience in the alcohol retail market makes entry into the cannabis retail sector an obvious fit. Liquor Stores could easily become the most significant cannabis retail store in Alberta.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$10.14	10.56%
Palos Equity Income Fund - RRSP	PAL 101	$6.65	9.35%
Palos Merchant Fund L.P. (Sep 29, 2017)	PAL 500	$4.21	5.36%
Palos WP Growth Fund - RRSP	PAL200	$10.30	2.96%
S&P TSX Composite			7.80%
S&P 500			20.49%
S&P TSX Venture			55.27%

Chart 2: Market Data*

	Value
US Government 10-Year	2.41%
Canadian Government 10-Year	1.89%
Crude Oil Spot	US $57.40
Gold Spot	US $1,274.30
US Gov't10-Year/Moody BAA Corp. Spread	190 bps
USD/CAD Exchange Rate Spot	US $0.7754

PALOS
INVESTMENT FUNDS

November 30, 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

■ What is New on the Macro Level?

By Hubert Marleau

In the Short-Term it Boils Down to U.S. Inflation

What is inflation? It reflects a reduction in the purchasing power per unit of money. It occurs when there is a sustained increase in the general price level of goods and services over a long enough period. Inflation is attributed to changes in real demand for goods and services or in available supplies. It is usually caused by demand pull when money is too easy for too long and/or by cost push when labour-input is too scarce. As a rule, the monetary authorities like an annual rate of inflation of 2.0%.

Presently, the Fed's preferred gauge, the personal consumption expenditures price deflator, is up only 1.4% in the latest twelve months, excluding food and energy prices. Many economists are puzzled over why inflation is as low as it is. Firstly, the economy has reached full employment and, in turn, signs of cost push pressure should be present. Secondly, the monetary conditions have been accommodating for years and, in turn, signs of demand pull should also be present. As a matter of fact, Federal Reserve Chair Janet Yellen has voluntarily admitted that "persistent sub-2% inflation is a mystery given that the unemployment rate has fallen as low as 4.1%, below a level considered as full employment. In our judgement, there is no inflation puzzle. In the more widely watched consumer price index, inflation is running at the annual rate of 2.0%. In this regard, the inflation-objective of the Fed has been met.

The New York Fed has come out with a new leading indicator of inflation called the Underlying Inflation Gauge (UIG). The UIG, contrary the core-inflation measures that cull food and energy prices, is a full data set for it adds numerous variables in the hope of separating the signal from noise of the actual trend in prices. Back testing shows that it gave better and earlier signals of subsequent falls and rise in inflation than other indicators. Consequently, UIG is gaining public and official attention for its suggesting that year-on-year inflation rate of 2.96% and an actual trend rate of 2.25%-3%, well above the actual annual rise in either headline CPI (2.0%) or core CPI (1.8%). Additionally, the Atlanta Fed has a dashboard of inflation indicators and they all strongly suggest that the mission of running the inflation rate at the annualized rate of 2.0% is accomplished. For example, business inflation expectations inched up in October to a year over year increase of 2.0%. Deflation probabilities as of November 21 were merely 4.0% and sticky-CPI is showing that inflation is annualizing at 2.2%. More importantly, the Cleveland Fed has come up with a new tool to provide daily nowcasts of inflation for two popular price indexes, the price index for personal consumption expenditures (PCE) and the consumer price index (CPI) called "Inflation Nowcasting". These forecasts help to give a sense of where inflation is right now and where it is likely to be in the future. On November 28, Inflation Nowcasting predicted that the CPI was be up 2.2% in November, Core CPI (1.8%), PCE (1.7%) and Core PCE (1.7%). Lastly, the Phillips curve which implies that inflation tends to move in the same direction as the overall economy may be working out better than the multitude of explanations given as to why low unemployment has not raised the Core PCE Index to the Fed's 2% target. Two researchers (Tim Mahedy and Adam Shapiro) at the Federal Reserve Bank of San Francisco have come up with an interesting idea that usefully explain the apparent misbehaviour of the Phillips curve. They divided inflation into two baskets: procyclical goods & services and acyclical goods & services. Goods and services whose prices fluctuate with the macrocycles like the cost of rent are contributing the same amount of inflation as they did during the 2002 to 2007 cycle. Goods and services whose prices respond little to macrocycles like college education, health-care and semiconductors are contributing about 0.6% less than they did in the same years. The math shows that core PCE inflation would be about 2.0% if acyclical inflation behaved like it did in the mid-2000s.

The bottom line is that the U.S. economy is approaching its potential. The above analysis is giving credence to the argument that the reflation effort of the Fed is slowly but surely bringing about the desired inflation rate. We may draw two conclusions. Firstly, the Fed is certainly on track to hike interest rates at the next FOMC meeting. Secondly, given that the economy is operating at full employment and prices are running at the Fed's target rate, the federal funds rate, after the expected December hike, will likely be close to the level that is considered neutral. Interest rates are neither making the economy too hot or too cold, but just right. As a matter of fact, the U.S. GDP growth was just revised up to 3.3% for the third quarter resulting from more business investment in equipment and software than previously estimated. The nonpartisan

PALOS
INVESTMENT FUNDS

November 30, 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

Congressional Budget Office has figured out that total economic output is now running at the maximum sustainable level. Now that the US economy is in a sweet spot, the Fed may begin to think that it may a good time to make financial stability the leading objective of monetary policy. Jerome Powell is the man that can do it.

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