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# Palos Weekly Commentary

## ■ Palos Funds

*By Charles Marleau*

### Back on the Train

Canadian Energy companies are suffering from a lack of pipeline infrastructure. Canadian producers have become price takers as they have no flexibility to move oil to the market with the best price. However, when the differential between Canadian and U.S. oil rises above a certain spread, it becomes economical to send oil by rail around North America. The spread has now reached its tipping point and producers are now once again shipping oil by rail. Moreover, railroad companies have been discounting some shipments. For example, a trip to Texas can cost about \$12 a barrel, compared with \$10 via pipeline.

On August 12, 2014, Secure Energy Services (TSX:SES) announced a strategic acquisition of Predator Midstream Ltd. This acquisition included three transloading rail terminals that give their customers access to a fleet of 275 rail cars. In hindsight, the timing of this acquisition by SES could not have been worse. Two months later, oil prices imploded from \$100 a barrel to somewhere in the \$40's. SES never benefited from the

acquisition as it quickly became uneconomical for producers to send oil by rail. Management has indicated that volumes of crude sent by rail have been increasing week-over-week at SES. We believe that SES has probably been running its rail terminals at full capacity for the past few weeks. Most analyst estimates currently have this division inactive and not contributing to the bottom line. Consequently, the market could be in for a nice surprise in Q4.

There are other indications that transporting oil by train is once again moving forward. For example, Plains Midstream Canada announced that it was reopening its train-loading facility. This is a positive for Canadian Pacific Railway LTD (TSX:CP) as it serves the Plains Midstream terminal. In 2014, at the peak of the oil differential, CP's crude revenue was \$480 million. Palos believes that CP and SES are the best way to take advantage of this opportunity.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	\$10.09	9.92%
Palos Equity Income Fund - RRSP	PAL 101	\$6.60	8.51%
Palos Merchant Fund L.P. (Sep 29, 2017)	PAL 500	\$4.21	5.36%
Palos WP Growth Fund - RRSP	PAL200	\$10.08	0.81%
S&P TSX Composite			7.49%
S&P 500			20.05%
S&P TSX Venture			55.22%

**Chart 2: Market Data\***

	Value
US Government 10-Year	2.36%
Canadian Government 10-Year	1.85%
Crude Oil Spot	US \$56.69
Gold Spot	US \$1,249.80
US Gov't 10-Year/Moody BAA Corp. Spread	186 bps
USD/CAD Exchange Rate Spot	US \$0.7779

\* Period ending Dec 7, 2017

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## ■ What is New on the Macro Level?

*By Hubert Marleau*

### On Canadian Monetary Policy

On December 6, the Bank of Canada announced that it would keep its benchmark overnight interest rate at 1.00%. In our way of thinking, the Governing Council should have raised interest rates by 25bps to 1.25% while “the sun was shining.”

Statistic Canada printed that the economy’s strong run of real growth waned in the quarter ended September 2017 from an annualized rate of 4.0% to 1.7%. This slowdown stemmed from a sharp retreat in exports. On a year over year basis it was not so bad for N-GDP rose 4.9%. Inflation accounted for 1.9% of the increase while employment and productivity respectively represented 2.0% and 1.0% of the overall increase. Given this level of aggregate spending, interest rates should be considerably higher. The Palos Monetary Policy Index, which looks at factors that the BOC normally rely on to make policy decisions like the employment, inflation, growth and international trade, presently stands at 138.0, below a recent peak of 175. This level is high enough to justify a rate hike. Moreover, the inflationary component of the Misery Index is now at 20% compared to only 14% last May. Contrary to our previous view that the Bank of Canada would delay interest rate changes until after a Fed decision, the blowout job growth for November changed our minds. The employment data for November was startling. In fact, 79,500 new jobs were created of which 30,000 were full time. The numbers were very bullish for the Canadian Dollar and, in turn, drove the loonie from 0.7675 US cents to slightly above its Purchasing Power Parity Rate. The Bank of Canada should have figured out that the economy can take higher interest rates and still have a cushion down the road. The Canadian monetary authorities can afford to take immediate action and take advantage of three other favourable circumstances.

Firstly, the threat of a financial crisis is easing. The Bank of International Settlements reported this week that their early-warning indicator which is known as the “credit-to-GDP gap” now stands at 9.4. The gap measures the ratio of debt of total debt ( Household, Business and Government ) to N-GDP, compared to its long-term trend. When this indicator is above 10, a country is considered at risk of financial strain on the banking system.

Secondly, terms of trades are improving. The latest pick up in oil prices has brought about a faster increase in export prices than import prices and, in turn, larger inflows of foreign money. For example, total exports rose in October for the first time in five months, increasing 2.7% to CAN \$44.5 billion compared to a decline of 1.6% in total imports to CAN \$45.9 billion.

Thirdly, Canada’s largest export market is growing at the highest rate in years. At this point, various high frequency tracking models are showing that the current pace of real economic activity in the U.S. is well above 3.0% and not in any serious jeopardy. Economic expansions do not die of old age. They die when macroeconomic conditions form glaring imbalances. Moody’s Analytics judges that the probability that the U.S. economy will fall into recession in six months remains low, falling from 5% in September to 2% in October.

In summary, it seems that Wednesday policy decision was not guided by incoming data but by subjective value judgements like the uncertainties surrounding NAFTA and housing. Logically, the exchange value of the Canadian dollar decreased to its PPPR at \$0.78 US cents and interest rate spreads re-widened in favour of the U.S.

### On Productivity

The U.S. Bureau of Labor Statistics printed that productivity rose at an annualized rate of 3% in the September quarter, much better than in the first half of the year and the strongest since 2014. As we expected, productivity appears to be improving and may continue to do so if business investment keeps on accelerating.

Productivity of labour is not doing as well in Canada. In the quarter ended September, Statistic Canada reported that productivity fell by 0.6%, the largest drop since 2015. Businesses are compensating for the lack of productivity gains with number of hours work by labour in the business sector. The prospects for change are not good. The country badly needs fiscal policies like tax relief and incentives that will promote business investments in software, R&D, equipment, intellectual property and structures. Next week’s commentary will discuss the yield curve and what is happening with copper prices.

*If you have any questions about the weekly commentary, the securities that we follow, or investment ideas, please contact us at [info@palos.ca](mailto:info@palos.ca)*