PALOS
INVESTMENT FUNDS

December 14, 2017

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■Portfolio Management & Advisors

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Joyeuses Fêtes!

Nous désirons vous souhaiter le meilleur pour la période des Fêtes. De plus, nous tenons sincèrement à vous remercier pour votre confiance et loyauté au cours de ces nombreuses années. Nous apprécions grandement votre contribution au succès de Palos. Nous sommes incroyablement fortunés de vous avoir tous, ce qui nous inspire à se surpasser dans notre accomplissement. Nous poursuivrons notre quête à gérer l'argent de notre clientèle avec le plus grand soin. Palos vous souhaite, ainsi qu'à votre famille, la santé, l'amour, la prospérité et la richesse pour la nouvelle année à venir.

Cordialement,

Charles Marleau

Veuillez prendre note que le commentaire hebdomadaire fait relâche pour les semaines du 28 décembre 2017 et 4 janvier 2018.

Happy Holidays!

Dear clients, friends, employees and suppliers of Palos, we want to wish you all the very best over the holiday season. Most importantly, we would like to thank you for your trust and loyalty over the years. We greatly appreciate everything that you have done for Palos. We are incredibly lucky to have you all, which inspires us to be better at what we do. We will continue to manage our client's money with the utmost care. Palos wishes you and your family health, love, prosperity and wealth for the coming new year.

Sincerely,

Charles Marleau

Please note there will be no weekly commentary on December 28th and January 4th

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$10.12	10.56%
Palos Equity Income Fund - RRSP	PAL 101	$6.62	9.35%
Palos Merchant Fund L.P. (Sep 29, 2017)	PAL 500	$4.21	5.36%
Palos WP Growth Fund - RRSP	PAL200	$10.25	1.49%
S&P TSX Composite			7.61%
S&P 500			20.77%
S&P TSX Venture			57.11%

Chart 2: Market Data*

	Value
US Government 10-Year	2.34%
Canadian Government 10-Year	1.84%
Crude Oil Spot	US $56.60
Gold Spot	US $1,253.80
US Gov't10-Year/Moody BAA Corp. Spread	184 bps
USD/CAD Exchange Rate Spot	US $0.7803

* Period ending Dec 13, 2017

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■ What is New on the Macro Level?

By Hubert Marleau

The 2018 Global Outlook Is Good

The latest Fulcrum nowcasts show that worldwide economic expansion is on track for growth at a 4.5% annual rate. Virtually every corner of the world is seeing better than expected economic performance. The Citi Economic Surprise Index for Japan, Euro-zone, U.S., U.K. and China are all above the zero line, a bullish indicator. Nevertheless, investors are starting to pay attention to what could happen in 2018. While cyclical turning points are difficult to foresee, it appears that the latest upswing will slow down within the 2018 calendar. Barring a China crisis, a dollar crisis, a debt crisis or geopolitical crisis, what will happen in the U.S. will be crucial for global economic activity. The U.S. economy dominates global markets, has the longest economic expansion among developed countries. The U.S. is also further advance in its credit cycle than most countries. While the exogenous shocks could upset the apple cart, the U.S. business cycle will probably be the single most important driver of investment performance in 2018 for the world as whole.

What is Going on in the U.S.

The U.S. market enjoyed a good ride in 2017. The S&P 500 is up a startling 20% resulting from undeniably healthy, profitable and coordinated global growth. The economic expansion has been going on for such a long time, eight years, that many investors are starting to ask if they should be concerned about a serious pullback in 2018. Nevertheless, a combination of financial deleveraging, diffusion of applied technology and growing business investment should keep the economic train on track through a revival in productivity gains. We think that the stock market will move higher in the first half of 2018 by as much as 7% before facing some headwind later in 2018 with a risk of a mild correction. Indeed, a short bout of cyclical inflation could erupt, or the Fed could make a policy mistake. A ten percent market correction is a real possibility. On the other hand, we do not foresee, at this time, either a bear market defined as a 20% fall in equity prices or a Minsky Moment defined as a sudden price collapse. The latter is usually sparked by a debt overload or currency pressures. Practically no high frequency models are betting on a recession nor are they alarmed by the age of the economic expansion. There is plenty of evidence that the economy still has plenty of room to expand. Productivity has started to show gains and employment growth is still occurring. Moreover, recent growth is not related to an unsustainable increase in consumer demand. Absent international trade, inventory accumulation, and business investments, real demand grew at the annual rate of 2.2% over the past two quarters. Given that the Trump tax cut is not going to boost R-GDP by more than 0.3% next year, growth will likely stay healthy but is unlikely to accelerate to the point of forming economic imbalances that could tilt the economy into a serious contraction. Many economic and financial agencies see very low probabilities of an ensuing recession in the next six to twelve months. Moody's Analytics and the WSJ's survey forecast less than a 15% chance of a recession occurring. The Business Cycle Index model is the most negative indicator putting the probability of a U.S. recession in the next twelve months at around 25%. It would seem that the market is in a phase of mature optimism and not in a state of euphoria. You can measure euphoria through margin debt and this indicator has not to take off. According to the NYSE, margin debt increased by only 15% in the year ended October 2017. History shows that margin debt needs to grow more than 40% year over a year before a major market peak is reached.

Nevertheless, investors should practice prudence and carefully follow "Now Casting Models" to check on growth, inflation and recession risk. Currently, the bulk of high frequency models suggest that the expansion will not be disturbed by a sudden surge in inflation, a sudden downdraft on growth or a sudden rise in recession risk. Yet, seasoned strategists make their predictions come true by forecasting often for they know that investors and other economic agents are ultra-sensitive to economic changes. Palos consistently monitors a dashboard of indicators like the standing path and destination of the yield curve, the gold to copper ratio, the U.S. dollar index, energy prices, real interest rates, market valuations, consumer sentiment and the differential between the neutral and policy rates. While the above indicators are reliable, they can be misleading and, therefore, they should be viewed as a group to sense similarities. As a group they can separate signals from the noise. It is very difficult to determine with certainty where we are at any given time in the business cycle. Yet, knowing where we are and where we are going can help to choose specific assets to maximize market return for a given amount of risk. Consequently, we use our dashboard of signals to check on the reality of our base case scenario in the hope of finding inflection points that can bring

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about investment shifts and different investment regimes.

Considering the FOMC decision to raise the Federal Funds rate another 25 bps, it seems appropriate to explain the what the yield curve means and judge its predictive power.

The U.S. Yield Curve

What's the yield curve?

It's a way to show the difference in the compensation investors are getting for choosing to buy shorter or longer-term debt. Most of the time, investors demand higher returns for locking away their money for longer periods due to greater uncertainty. Consequently, yield curves usually slope upward. (Bloomberg)

What is a flat yield curve?

A yield curve goes flat when the premium, or spread, for longer-term bonds drop to zero. In other words, the rate on 30-year bonds is no different than the rate on five-year bonds. If the spread turns negative, the curve is considered "inverted". (Bloomberg)

Where is the yield curve currently?

Last Thursday, the yield spread between ten-year bonds and two-year bonds was 50 bps and between three-month bills and two-year notes was 50 bps and between thirty-year bonds and five bonds was 50 bps. The yield curve is upward sloping but much flatter than it was just a few months ago.

Does it matter?

The simple answer is yes. The yield curve has an uncanny ability to predict recessions when the curve is inverted. The curve has been flattening in the past twelve months signaling possible danger ahead. It is worrying because a flattening yield curve that ultimately inverts has preceded every recession since the second world war. How long it takes a recession to occur after a yield curve inversion varies greatly. The shortest on record is just one quarter in 1957 and the longest lead time was two years in 2008. The average lead time is five quarters. Assuming that yields on ten-year treasury bond stick around 2.50% and that the Fed raises short term rates four times in 2018 to 2.50%, one could expect a recession to begin in June 2020.

Is this time different?

Many reputable strategists and economists believe that an inverted yield curve does not necessarily lead to recessions. The spread between 10-year Treasuries and overnight borrowing costs inverted nine times since 1960 without being followed by an economic contraction within the next two years. The big question is whether the Fed will stay on course to normalize interest rates or respond to inflationary concerns. In our view, we are much more in a Fed-hiking mode than in a macro-rising mode. Circumstances have dramatically changed from what they were in the past. Inflation risks have faded, geopolitical uncertainties are broader, the neutral rate has sharply decreased and quantitative actions on the part of central banks have caused a secular decline in the "term premium" offered by longer-term bonds.

What is the bottom line?

Rising bond yields combined with a steady upward sloping yield curve and gradual policy rate hikes would allow positive stock market returns. It's interesting that the gold to copper ratio is declining suggesting that the outlook is tilted more toward growth than inflation. In this regard, the Fed is acting prudently and wishes to get ahead of the curve. It should be noted that the market finds it unusual for the Fed to raise rates because inflation is stubborn and growth is taming. In turn, the market is only giving a 25% chance that the Fed will raise interest three times in 2018 as planned.

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