Issue 1

PALOS INVESTMENT FUNDS

January 4, 2018

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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	2017 Returns
Palos Income Fund L.P.	PAL 100	$10.31	12.53%
Palos Equity Income Fund - RRSP	PAL 101	$6.75	11.45%
Palos Merchant Fund L.P. (Sep 29, 2017)	PAL 500	$4.21	5.36%
Palos WP Growth Fund - RRSP	PAL200	$10.60	8.76%
S&P TSX Composite			9.10%
S&P 500			22.38%
S&P TSX Venture			65.81%

Chart 2: Market Data*

	Value
US Government 10-Year	2.43%
Canadian Government 10-Year	2.03%
Crude Oil Spot	US $59.92
Gold Spot	US $1,296.80
US Gov't10-Year/Moody BAA Corp. Spread	177 bps
USD/CAD Exchange Rate Spot	US $0.7954

* Period ending Dec 29, 2017

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■ What is New on the Macro Level?

By Hubert Marleau

The 2018 Stock Market Outlook

We've entered the new year with near record peaks in all U.S. stock indices running circles around most money managers. The bull market is on track to mark its ninth birthday in March of 2018, even with the S&P 500 climbing 18% in 2017. In fact, market internals like breadth indicators show broad-based participation arguing against a major top. Since 1945, the average trailing 12-month P/E ratio has been 17.5. History shows that six of the last 15 bear markets came from below-average P/E ratios. There is no threshold level that, once breached, gives investors a clear signal to get out. Furthermore, the level of interest rates does not offer much help either. Accordingly, there is no specific relationships between bear markets and valuation. (Palos has statistics that support this observation).

The tax cuts as well as the synchronization of global growth and productivity gains should drive the EPS for the S&P 500 towards $150 in 2018. This would put the forward P/E at 15.8x to produce an earning yield 6.50% and a ERP of 400 bps. Note that the IMF recently upgraded its forecast for global growth to 3.7% to reflect the apparent return to health of manufacturing in most of the developed world. Wall Street is predicting that the S&P 500 will not trade any lower than 2600 in 2018 and possibly as high as 3050. On Thursday, the S&P 500 ended the year at 2673. It means that 2018 should a decent year but not spectacular.

Nevertheless, many observers think that the stock market is overvalued because the cycle is too old, conventional metrics are too high and frothy conditions are emerging. While we accept that elevated valuations can mitigate subsequent market returns, we beg to differ. The secular trend is still bullish.

The stock market bull run is in its ninth year. The fact is that markets do not keep time. They keep going their own way until a wall is hit. Jeffrey Saut of Raymond James & Associates wrote a few days ago that secular bull markets last 15+ years and compound at around 16% per year. For example, the 1949-1966 secular bull market lasted 17 years and took the DJ Industrial Average from its June 1949 low of 161 to a high of 995 in February 1966. In 1982, the Dow broke out of its 16-year range bound market and commenced the 1982-2000 bull market. What we have is a "middle aged" bull run. There will be corrections, but it should be well noted by new investors that corrections are the price one pays to be right long term. Based on the assumption that the secular trend will not break and that bull markets do not die of old age, corrections should encourage investors to load up on stocks. The fact is that bull markets end with either a prospective recession or sudden burst in inflation expectation. These are usually associated with external shocks that come at us in unpredictable fashions that disrupt economic balances. Seasoned investors should keep a close daily watch on the path of gold and copper prices and their correlation as well as the relative performance of the U.S. dollar against other major currencies. These indices' patterns augur whether speculators are betting on growth or inflation. Palos will keep you abreast.

There are two things that the stock market does not like ---bouts of inflation and recessions.

1. On the inflation front, the Cleveland Fed has a high frequency model named "Inflation Nowcasting" that predicts a core inflation rate of 1.77% for the foreseeable future. This above prediction is supported by the 10-year breakeven rate, a proxy for the market's inflation expectations, which sits at 2.0%. Given that the inflation tracker that the Fed prefers—the core Personal Consumer Expenditures index—was up 1.5% in November, a move to 2.0% would not be terrible. It would only move 10-year Treasuries to 2.75% from 2.50%. It should be noted that the aggressive shift to e-commerce, price comparison and world trade should contain pricing pressure. Moreover, the Fed is likely to respond quickly if prices surge. It explains why the monetary authorities want to avoid this possibility by normalizing now for they fear inflation could take hold if they do nothing. In any case, the commercial banks are not translating their excess reserves into loans because they need to shore their balance sheets, adhere to banking regulations and get good marks on their stress tests. As a result, the annual rate of change in the money supply is about the same as that of the N-GDP. Also, the reduction in corporate tax rates is really about making American companies more competitive with the rest of the world. It may work as companies are more pass-through corporations than before and they may partially use their new operating surpluses to cut prices and/or expand their productive footprint. Lastly, the employment-to-population ratio is encouraging for it shows that there is still room for the labour force to grow sufficiently to overcome labour tightness. This ratio is still 4.0% below the

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pre-crisis level of 60.0% suggesting that many newly employed can come out of the woodwork.

2. On the economic front, the risk of having a recession in the next six months is only 2% and 14% in the next twelve months. Moreover, high frequency economic models are presently predicting that in the last quarter of 2017 real growth was running at an annual rate of 3.0%. Continued economic growth will be fueled by a global synchronized recovery, tax reforms, tax repatriation and expensing of capital expenditures. For example, close to $2.0 trillion could be repatriated to the U.S. In this regard, Goldman Sachs estimate that the tax cuts and repatriation will boost GDP by a reasonable 30 basis points in 2018 and 2019. For the first time in years, sales that businesses generate per employee is rising suggesting that perhaps the level of activity and growing scarcity of productive labour is pushing firms to consider more capex. There is evidence from the Philly Fed survey that companies are planning to increase their capital investment projects. The gap between those planning to raise capex over the next six months and those planning to cut capex expenditures has not been so large since 1984. In other words, it may be a long wait for those who are perma-bears. Bull markets do not die of old age. Bull markets end with economic contractions and/or inflation rising above 4.0%

3. There is little doubt that the stock market is often dependent on human psychology that cannot be economically measurable. Wild corrections happen in markets that are either immature or inefficient which have been in the grip of a gambling bubble. It is not something that is grounded on robust economic laws, theories or hypotheses. One may believe that the last round of increases in stock prices represent bubbly conditions. In our judgement it does not hold-up. For example, the stock prices are up 18% in 2017 and they reflect more or less the expected increase in earnings for 2018 resulting from Trump's tax cuts. As a matter of fact, sentiment surveys show that the consensus remains quite cautious on stocks, with an unusually large majority of opinions in fact neutral. Moreover, rising capital and liquidity ratios at all financial institutions is reducing systematic risk. Various financial stress indicators (St-Louis Fed, NY Fed, GS) are in non-fearful zones.

4. Coming out of the holiday season, the bullish stock market trend remains in place despite the fact that valuations are elevated. The stock market moves have a lot more to do than just earnings. A recent study at Morgan Stanley showed that since 2011 some 52 percentage points of the S&P 500's return came from earning growth, another 40 points came from investors' increasing willingness to pay more for stocks. In addition, 30 points resulted from dividends and 8 points is related to share-buybacks. Other bullish periods show very similar characteristics. In our judgement, a new investment environment is spawning. A growing number of companies are considering spending a lot more on capital improvements, research and development and digitization of the enterprise. A December survey conducted by Wolters Kluwer Blue Chip Economic Indicators predicted that business investments in real terms will increase 4.7% in 2018. It is conceivable that spending on items that have long term productive use or long-term profitability outlook could account for 28% of R-GDP---a 20 year record.

5. Given that the fed is expected to continue to normalize interest rates by raising the federal funds rate and letting its bond portfolio shrink as it matures, there are concerns that the tightening process could invert the yield curve and lead to an economic contraction in 2019. We think that the $2.5 trillion monetary stimulus will largely be unaffected because of its huge size. Indeed, the U.S. economy can take some gradual quantitative tightening and as much as four rate hikes before a protracted inversion of the yield curve sets in. The combined impacts of deregulation, tax cuts and intended infrastructure spending should offset the anticipated tightening effect of the Fed. It is also worthy of consideration that there is a big difference if an inversion of the yield curve is a byproduct of high inflation or high productivity gains. We have put forward on several occasions that the U.S. economy is on the cusp of major productivity gains.

The Productivity Thesis

Anecdotal economic readings like those presented by the various regional Federal Reserve Banks show "goldilocks" number. And, this is what the stock market likes. The U.S. economy has been growing above recent averages and inflation is running below averages. Whether this situation persists is dependent on how productivity will evolve over the forthcoming period. We are optimistic. Productivity solves problems and enhances economic welfare. Basically, productivity tends to decrease inflation, increase profitability, increase hourly wage rates, raise real rates, ease the burden of debt and improve overall economic activity. To the extent that rising

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productivity leads to higher potential output, the monetary authorities may not need to normalized interest rates as quickly as suggested in the latest FOMC report.

The Bureau of Labour Statistics reported that nonfarm business sector labour productivity grew at a 3% annual rate in the third quarter. Over the last four quarters ended September 2017, productivity is up 1.5%. There is a growing chance that productivity growth in the fourth quarter of 2017 will be north of 2.5% followed by a similar increase in the first quarter of 2018. Since 2005, the annual growth rate averaged only 1.3%.

One should not be overly concerned with the apparent contradiction between forward-looking technological optimism and backward-looking disappointment for they are several reasons why advancements in technology have not been totally reflected in the productivity numbers. Firstly, smartphone apps and news feeds are constantly grabbing people attention and distracting workers away from their work. Research shows that people check their phone 150 times a day or roughly once every 6 minutes. Theses distractions like emails, notifications and media socializing are weighing on productivity for workers are not paying continuous attention to work and directly reduce the quality of their work and persistently lower the capacity to work. Individuals and organizations are countering the fall in attention spans by 1) embracing single-tasking as a mode of working, 2) by offering courses in mindfulness and 3) by understanding the link from attention to productivity. Secondly, the bulk of advanced technology has had more of effect on inflation than output. As a result of apps, computer power and internet, consumers have taken the effort of producing and selling goods and services away from businesses effectively reducing cost and, in turn, holding or decreasing prices. Thirdly, the consequence of allocating a growing proportion of the working population to industries with relatively low rates of growth like health care and education is another cause. These occupations have accounted for more than half of total employment growth since 2000. A recent McKinsey study demonstrated that AI and blockchain could be transformative for the service industry and may be more impactful than the rise of computers.

In a recent book called “Capitalism without Capital” the authors argued that intangible investments which are largely scalable with huge spillover effects are gaining momentum. One study suggests that in 1948, American intangible investment accounted for about 4% of non-farm business-sector output. By 2007 this ratio had grown to 14% and was probably near 20% in 2017. The expertise that coding and engineering provides to the value of a company indicates that something is going on. Microsoft’s physical assets account for just 1% of its market value. This means that investors are betting that branding, R&D and applications of technology are vastly more important than anything else for productivity. Mathematically, this 20% number indicates a new trend. In our view, robotics, blockchain and big data combined with machine learning devices are “General Purpose Technologies” as much as electrification and internal combustion engine was at the of the 19th century. There comes a time, according to a NBER working paper produced by Erik Brynjolfsson, Daniel Rock and Chad Syverson, when the stock of new technology is large enough to affect business models forcing complementary investments. History demonstrates that such breakthroughs bring about important shifts in productivity growth. The University of Toronto came out with a recent study that shows that M&A activity related to AI increased from 20 deals in 2015 to 120 in 2017 for an increase in value from $4.0B to $24.0B. AI related research is skyrocketing. Microsoft has produced 1000 papers on the subject matter while Google and IBM produced 400 and 350 papers respectively.

Further Notes on AI

Economic theory tells us that anxiety about robots, AI and other technological advancements is groundless. History suggests as much. Previous waves of job destruction led to an equilibrium between supply and demand in the labour market at a higher level of leisure, employment and earnings. Attaching technology to workers increases their output for each hour they work. They ended up with the enviable choice of working less for same wages or work the same for more pay. The cost of existing goods tends to fall leaving consumers with more money to spend. Either way, there is no reason to expect a net loss of jobs. The trend is irreversible for when one learns to do something more efficiently, there is no way that one will go back.

A consortium of economists from MIT and Harvard, including Erik Brynjolfsson, launched an AI index to compile and track developments in AI. The index will make it easier to see what is happening within the general-purpose technology will be disseminated to whomever is interested.

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Off course, we will be on it for it will help us to monitor what is happening and see if a tipping point in productivity trends has indeed occurred.

Few pursuits found such widespread application in 2017 as AI. Software that relies on a form of AI, known as neural networks, reached superhuman levels in chess, Go and Shogi, learning to play games using trial and error, not by studying human play. Research demonstrates the potential of AI in healthcare and education. For example, AI can spot patterns of diseases that human doctors cannot. AI is now used for real time translation between languages, powering voice assistants and organizing photos. These are real successes. AI has become synonymous for the term "smart" often applied to technologies that contain AI. The Association of National Advertisers in America chose the acronym as its "Marketing Word of the Year". AI is just beginning. Companies will increasingly build software products using large volume of data to train neural networks. The world will keep getting smarter. AI is just making that process faster.

Mobile payments are getting much more convenient. According to McKinsey, small scale businesses as well as web markets are increasingly accepting mobile payments for services rendered and goods sold. This method of payment combined with e-commerce is growing very fast representing almost 20% of total retail sales. Mobile payment is bringing about huge savings, a lot of data knowledge, cost efficiencies and off course productivity for making cash almost obsolete.

Matt Ridley, best known for his insightful writings on science and economics, wrote in the Financial Times a few days ago that AIs are augmenting and not replacing people for there is a "human-technology symbiosis" going on. In his arresting analogy, AI would be to us as fig wasps are to fig trees: symbiotic partners. This symbiosis is both true and spreading to many sectors. At a Microsoft lab, experimental systems do in seconds that which would take a radiologist hours. Google's Deepmind, algorithms are preparing to save the search engine company a fortune in energy bills by rethinking its electricity distribution system. In the foreseeable future we will gain huge amounts of symbiotic driver assistance in the private cars. We are already getting driverless trams, tractors and trains. The spillover effects on productivity cannot be neglected. The Institute for Public Policy Research (IPPR) thinks that there is likely to be tremendous potential for productivity dividends as technological changes redirect savings to the consumption of social goods and infrastructure and, in turn, expand employment in the provision of these services. The IPPR says that "the chance is less mass joblessness and more the paradox of plenty. An age of abundance brought about by changes in technology and productivity eventually results into richer societies.

In the period from 1871 to 1940, the yield curve was for most part perpetually inverted. One can say that it either predicted everything or nothing. This confirms that at times, an economy is capable of sustained growth and a number of economic and stock market cycles along the way with a yield curve that is inverted. The question is why. History shows that during the period under review, the economy enjoyed a major technological transformation that lead to low inflation rates and high productivity growth. One could argue that low inflation kept bond yields low and high productivity fueled demand for money forcing the yield curve to stay inverted. For more information read the book titled the "The Rise and Fall of American Growth" by Robert Gordon.

It is true that real wages have not done much in the past 20 years, but the standard of living has significantly improved. Because of shorter working hours, longer holidays, longer periods of education and longer retirement, the proportion of life spent at work as opposed to sleeping, consuming, learning and holidaying is dramatically shrinking. This reflects Matt Ridley's symbiosis between people and technology.

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