Issue 5

Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

N'oubliez Pas!!! / Don't Forget!!!

(English to follow)

Comme la période des déclarations de revenus arrive à grands pas, je profite de l'occasion pour vous rappeler de tirer pleinement parti de vos comptes de placement à l'abri d'impots en cotisant à votre REER et à votre CELI avant la date limite. Ces régimes sont des moyens très efficaces d'épargner en vue de la retraite et d'autres objectifs à long terme, tout en économisant de l'impôt. Vous trouverez ci-dessous des renseignements supplémentaires.

Renseignements sur les cotisations au REER

- Pour l'année 2017, **la date limite** de cotisation à un REER est le **1er mars 2018**.
- Votre plafond de cotisation pour 2017 tient compte de tous les droits de cotisation inutilisés reportés de 2016 ainsi que de la cotisation maximale pour 2017 (18 % du revenu gagné de l'année précédente, à concurrence de 26 010 $, le plafond établi pour 2017).
- Si vous avez déjà cotisé à votre REER pour l'année 2017, envisagez de verser votre cotisation pour 2018 dès maintenant afin de profiter de la croissance à l'abri d'impôt. **Le plafond de cotisation au REER pour 2018 est fixé à 26 230 $.**

Renseignements sur les cotisations au CELI

- Le **plafond de cotisation annuelle** pour 2018 est de **5 500 $**.
- Depuis sa création en 2009, les droits de cotisations à un CELI s'accumulent chaque année. En 2018, le plafond de cotisation a atteint **57,500 $**.

As tax time approaches, I take this opportunity to remind you to take full advantage of your tax-sheltered investment accounts by making contributions to your RRSP and TFSA. These plans are highly effective ways for you to save for retirement and other long-term goals, while providing tax-savings opportunities. Please see below for more details:

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$10.05	-0.77%
Palos Equity Income Fund - RRSP	PAL 101	$6.62	-0.80%
Palos Merchant Fund L.P. (Sep 29, 2017)	PAL 500	$4.21	5.36%
Palos WP Growth Fund - RRSP	PAL200	$10.50	-1.48%
S&P TSX Composite			-1.96%
S&P 500			5.68%
S&P TSX Venture			-0.81%

Chart 2: Market Data*

	Value
US Government 10-Year	2.79%
Canadian Government 10-Year	2.37%
Crude Oil Spot	US $66.00
Gold Spot	US $1,348.10
US Gov't10-Year/Moody BAA Corp. Spread	158 bps
USD/CAD Exchange Rate Spot	US $0.8152

* Period ending Feb 1, 2018

February 1, 2018

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RRSP Contribution Details

- The **deadline** for making your 2017 RRSP contribution is **March 1, 2018**.
- Your 2017 RRSP contribution limit is based on any unused contribution room carried forward from 2016 plus your 2017 contribution amount (18% of the prior year's earned income, subject to a ceiling of $26,010 in 2017)
- If you have already made your 2017 contribution, consider making your 2018 RRSP contribution now to benefit from the tax-sheltered growth of an RRSP. **The maximum RRSP contribution limit for 2018 is $26,230.**

TFSA Contribution Details

- The **annual contribution limit** for 2018 is **$5,500**.
- Starting in 2009, TFSA contribution room accumulates every year. Unused contribution room carries forward, currently up to **$57,500**.

■ What is New on the Macro Level?

By Hubert Marleau

The Outlook for the U.S. Economy

Gross Domestic product (GDP) is by far the most important economic metric in the world. It is defined as the measure of a country's economic output expressed in either real or nominal terms as a single monetary value. How fast GDP grows is the basic indicator of economic development, well-being, and geopolitical power. While we hear that the objective of central banks is full employment and price stability, the reality is that GDP growth is the main materialistic goal of governments. GDP growth over time determines the performance of forex, bond, stock and commodity markets. This metric deserves special attention. Palos pays a lot of attention to U.S. quarterly GDP numbers as it the basis of all our market forecasts.

Preliminary estimates released by the Bureau of Economic Analysis (BEA) reported that the U.S. economy, in real terms, grew at an annual rate of 2.6% in the three months ended December 2017. It's the third quarter in a row where the growth speed surpassed the 2.0% average pace of the last eight years. If it had not been for depleted inventories and higher trade deficits, the strength of the national output would have been better than the headline numbers indicated. The pace of growth would have been north of 4.0%. This growth demonstrates the resilience of the U.S. economy and augurs well for the first quarter of 2018.

Palos likes to review the GDP reports on a year-over-year basis. Year-over-year comparisons eliminate the noise and usually provide a more reliable idea of what is fundamentally going on in the economy. We also like to review the performance of the economy in physical and monetary terms while searching for imbalances that may hurt the outlook.

1. N-GDP in the fourth quarter of 2017 increased 4.4% from the comparable period of 2016. Employment growth accounted for only 1.2% of the increase and gains in productivity contributed a healthy 1.3%. Inflation provided the rest of the growth with an annual rate of 1.9%. It should be noted that productivity has been on an uptick since the second quarter of 2016. Non-residential investment increased 6.3% in real terms for the period under review accounting for 33.5% of the $420 billion increase in R-GDP. The effect of the tax overhaul, according to early reports, is widening. Many corporations are re-evaluating existing projects and/or exploring new investments in structures, equipment and intellectual property products. As we have alluded to in past commentaries, a tipping point in productivity may have already occurred.
2. Viewed in another way, the entire increase in aggregate spending has resulted from the growth in the money supply. Monetary theory argues that aggregate spending is connected to the money supply and its velocity. This is particularly interesting because for the first time in years, the velocity of money has decreased. It should be noted that history shows higher inflation rates are highly correlated, with causality, to a rising turnover of money.
3. Unfortunately, the December quarter was not absent economic imbalances. There are three issues that needs to be monitored for they could eventually obstruct the recent upward path of growth. Firstly, according to the CBO, a non-partisan government body, there has not been a pickup in the underlying growth rate of potential output. If the latter is true, then the uptick in productivity would not be enough to compensate for negative demographic conditions. This means that a

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good part of the recent gains in the level of economic activity is cyclical. Cyclical upswings usually end when full employment brings about higher inflation. Secondly, increases in personal disposable income have not kept up with personal expenditures nor retail sales. The personal saving rate has fallen to 2.4% suggesting that households have loaded-up with debt or draw on their savings to keep-up with the Jones. If workers are not going to get better wages, consumers will not continue to be the driving force behind the growth that we have witnessed of late. Thirdly, the current account deficits and the budget deficits, better known as the twin deficits, account for 6.2% of N-GDP. This is already above the critical mark that the IMF considers concerning. The new GOP Tax cuts will likely increase both deficits in 2018 to perhaps as high as 8.5%. Given that the U.S. economy is in a fundamental dissaving position, reliance on foreign capital to finance these large deficits could become problematic.

There are several conflicting forces that make forecasting difficult. One never knows where the chips will fall. Accordingly, Palos extrapolates what is presently going on as a base-case scenario and continuously creates forecasts based on recession and financial risk indicators, and high frequency economic models, employment, and inflation models. At this poin, the probability that a recession will happen in the next six months is only 5%. High frequency economic models are pointing to a 2.5% annual growth factor and a rate of inflation of 2.1% for the March quarter of 2018. If we assume that the current unemployment rate holds steady at 4.1%, the job calculator of the Federal Bank of Atlanta suggests that the annual increase in employment would come in around 1.0% and, therefore, productivity at 1.5%. These new numbers suggest that ten-year treasury yield should not be any lower than 2.65% but not any higher than 3.30%. Our base case scenario is 3.00%.

The Outlook for the U.S. Economy

From 2010 to 2017, productivity grew at the annual rate of 0.6% and employment by 1.5%. Something happened during the second quarter of 2017. The much-lauded "Fourth Industrial Revolution" arrived. It appears from numerous articles in reputable editorials and scientific magazines that the rise of ubiquitous automation, robotics, big data, artificial intelligence and blockchain is finally upon us. We believe that productivity turned the corner and an inflection point occurred in the quarter ended June 2017 when productivity increased at the annual rate of 1.6%. Productivity grew at 1.4% in the following quarter and 2.2% in the last quarter of 2017. Our estimate for the first quarter of 2018 is 1.6%. The U.S. economy needs these productivity gains if it's going keep rolling because the demographics for increase employment look bad. The pool of working-age population is stagnating, and immigration levels are frustratingly low. The estimated employment growth for the current quarter is 0.9% if the labour participation rate increases.

Yili Cien of the Federal Bank of St. Louis identified three main factors that drive economic growth. These are

1. Accumulation of capital stock
2. Increase in labour inputs like number of workers and hours work
3. Technological advancement

Growth can be broken down by accounting for what percentage comes from capital, labour and technology. Technology progress and capital accumulation are what create long term labour productivity growth. Studies show that by holding labour input factors constant, additional output occurs each time one extra unit of capital or technology is added. The explanation may be simple. However, progress is not linear as technology and capital is subject to the laws of marginal utility and diminishing returns. Structural forces like changing societal wants and disruptive political issues can interrupt what should be pretty straight forward path.

On the Stock Market:

Warren Buffett's favorite valuation metric is the comparison of the market capitalization of the total market with GDP. Joseph Becker at Milliman Financial Risk Management adds the market capitalization of the Russell 1000 and BofAML US Aggregate (US High Yield and US Municipal bond Indices) and runs them against the N-GDP. The ratio is 275%, the highest it has ever been suggesting that valuations reflect low interest rates. If the performance of the stock market does in fact reflect the performance of the economy, then stock market returns may be running too fast with valuations elevated. Given our assumption that ten-year treasury yields are heading toward 3.00%, stock market returns can only be a function of future earnings.

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Consequently, the stock market will probably be more volatile than it has been of late making risk management and trading essential to achieve some alpha and superior returns. It will become essential to watch the effects of the GOP tax cuts, the productivity increases, lower dollar value and higher producer prices on operating cash flows.

On the U.S. Dollar:

The U.S. dollar is the main reserve currency of the world monetary order. It has assumed this role out of choice and not by mistake. Treasury Secretary Steven Mnuchin is not stupid and when he touted the benefits of a weak dollar in Davos it was not an off-the-cuff gaffe but an attempt to message to the world that the U.S. wants a new deal like conventional mercantilism. It fits with the administration's protectionist measures and harsh trade rhetoric. In other words, it was part of a coordinated policy strategy to correct an unbalanced trade account deficit. This is breaking with the long tradition of sticking to a strong dollar mantra. Economic history is clear about weak currencies. It's benefit of cheaper exports does not compensate for higher import prices, more expensive capital, lower purchasing power, less foreign capital. There is alos the possibility that the weak currency can be left behind as a conscious decision on the part of other world players. While the U.S. has stood back from the Trans-Pacific Partnership, thrown NAFTA into uncertainty, and put the South Korea trade agreement in doubt with no US ambassador in Seoul, the rest of the world has doubled down on globalization with a self-conscious mission to buttress the liberal international order. Meanwhile, China is shaping the global economy by filling the gaps caused by the absence of the US. China's economic diplomacy, centered on the geostrategic Belt and Road Initiative, is more significant than anything Trump had to say in Davos. There are good reasons why past Treasury secretaries pushed for a strong dollar. They did not want to lose the extraordinary privileges that a strong reserve currency gives like riskless and cheap financing. It should be noted that productivity, like many other things in economics, also needs to be financed. It would a shame for the U.S. to miss out on productivity gains for the sake of reducing the trade deficit by a few billion dollars. I trust that once again the Fed will come to the rescue and help the dollar find firm footing. Moreover, other central banks have manifested their unhappiness with the weak dollar. In any case, according to Brown Brothers Harriman, "policymakers' wishes are hardly the stuff that makes for durable trends in foreign exchange markets". Trump wants to look successful and may amend his anti-globalism philosophy for the sake of being on the winning side. It's what a stable genius would do. In essence, the US is consuming much more than it is capable of producing and, accordingly is importing the difference. To reduce this deficit, Americans must dampen private consumption of luxury goods and encourage merchandise exports. The later accounts for only 7.8% of N-GDP compared to 40% in Germany.

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