PALOS
INVESTMENT FUNDS

February 8, 2018

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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	$9.53	-5.91%
Palos Equity Income Fund - RRSP	PAL 101	$6.31	-5.41%
Palos Merchant Fund L.P. (Sep 29, 2017)	PAL 500	$4.21	5.36%
Palos WP Growth Fund - RRSP	PAL200	$9.79	-8.11%
S&P TSX Composite			-6.87%
S&P 500			-3.32%
S&P TSX Venture			-3.69%

Chart 2: Market Data*

	Value
US Government 10-Year	2.82%
Canadian Government 10-Year	2.38%
Crude Oil Spot	US $60.42
Gold Spot	US $1,320.90
US Gov't10-Year/Moody BAA Corp. Spread	162 bps
USD/CAD Exchange Rate Spot	US $0.7935

* Period ending Feb 8, 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 Stock Market

On most days, no one knows why stocks are up or down. This is particularly true with sudden market moves. I hate to admit it, but we should have seen this one coming. After hitting its highest level in a decade, household confidence in the economy slipped for the third month in a row in January. The University of Michigan's index is 1.1 points below the 2017 average of 96.8, which was the highest yearly average in two decades. Put simply, it is normal to feel a little less confident about the economic outlook when things are already as good as it gets. Martin Sandu explained that the market fell because many investors thought it would fall. Investors thought it would fall because they thought many other investors thought it would fall and so on. Indeed, mobs of people don't always act rationally in response to information; they react to how they think other people are acting or will act.

It is popular to say that the stock market is not the economy. It's obvious that the economy is not the market; but it is equally obvious that they are related. Consequently, analysts look to the economy for explanations. The standard narrative is that the economy has run out of spare capacity signaling a regime shift to higher inflation and higher interest rates. This suggests that the stock market was too expensive. Hence the 10% correction. I don't buy the argument. The 2.9% annual wage growth that was registered in December is well within what the economy can sustain without pushing the actual rate of inflation much beyond 2.0%. It appears that average hourly earnings have been spurred by a shorter work week, a one-time repricing of minimum-wage, bonuses, and a small subset of nonproduction workers. Put simply, wage gains are not very widespread. Market-based and economic-based inflation gauges have not moved dramatically suggesting that the out-of-hand inflation narrative does not hold at this time. Because of decent productivity increases, higher wage rates may not translate into more inflation. There's little sign that prices are poised to break significantly above the 2% increase targeted by the Federal Reserve. Kashkari, the Minneapolis Fed President, said that market concerns about the economy overheating have no basis in the data. It is interesting to note that many are choosing to enter the workforce in a modest-wage-growth environment. Therefore, we may have a way to go in this cyclical recovery making it possible to run a faster growth trend than 2.0% for next while. In fact, during the last two expansions, annual wage growth peaked at 4%.

In our judgement, the market got ahead of itself. Machine-based traders and risk-parity funds took over while human investors that are rule-base bought the dips. (An analysis by Schroders Plc shows that fund managers who buy big dips do well. For example, of the 10 biggest one-day declines in the past 30 years, the stock market returned 25% on average over the next 12 months. The data underlines the strength of equities over the long term). Quant models are complicated and have no human interaction and it is therefore hard to rationalize the erratic trading rout. What we do know is that the abruptness of intraday price swings are accentuated by algorithms that need to rapidly adjust to new market realities. The brutal selloff followed by wild swings tells us that the world is a risky place. The VIX is now pricing the equivalent of a 2% S&P 500 move up/down each day for the next month. Viewed another way, the market-implied probability of another selloff in excess of 5% over the next two weeks is 25%. According to Martin Novak, a mathematical biologist and economist at Harvard, markets move in cycles of cooperation. "When everyone's working together for a common goal, we get rich. Then bad actors realize they can game the system, and start misbehaving. Trust breaks down and

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suddenly everyone is sniping at everyone else. The market becomes riskier until cooperation is seen as the only remedy. Then the cycle starts again." Since the financial crisis central banks and major governments have coordinated their monetary and fiscal policies to ensure a cooperative mindset. Perhaps, the advent of populism is breaking the cycle of trust as non-cooperators are on the ascendancy and the investment climate is now reflecting this new reality.

It is very important in time like these to keep the long view in mind. Stock market returns are a function of valuations, financial conditions and economic outlook. At this time, there is no stress in either the banking or financial systems and no elevated risk of a recession. High frequency models are showing that the economy is rolling with little evidence that inflation is getting out of hand. There are no clues that recent volatility is creating damage to the real economy meaning that the rout was way more technical than fundamental.

We are sticking with our base case scenario that ten-year treasury yields will trade in a sustainable manner near 3.00% sometime in 2018 and that the S&P 500 will generate earnings per share of $155 for the twelve months ending December 2018. Given that the S&P 500 has fallen by as much as 10% from its recent peak of 2875, valuation metrics are obviously more alluring. At 2600, the forward P/E is 16.75 times generating an earning yield of 5.97% and a normal equity risk premium of 2.97% if ten-year treasury yields ends up around 3.00%. Assuming that profit will grow at an annual highly conservative rate of 2.00% over the coming years with a fair discount rate of 8.00%, the present value of the S&P 500 is 2650. If we were to increase profit growth to a reasonable 2.5%, we would end up with a present value of 3125 for the S&P 500. It should be noted that the reason why we think corporate profit growth will be somewhat slower than N-GDP annual increase of 4.0% is because the reflation scenario should be more of an outcome of cost push than demand pull pressures. While the mathematics says that the correction may be over, or at least trying to find a bottom, a return to normal risk is kicking in because the financial repression of the Fed is ending. From hereon, one should expect normal stock market returns under more volatility.

The Global Oil Complex: The U.S. as an Energy Surplus

The last time we wrote about the global oil complex, we argued that there was a good chance that oil prices were heading higher because OPEC was complying with the decision to cut production in spite of fast growing global demand. The WTI oil price reached $66.22 a barrel on January 26, 2018. That is about $10 above our estimated marginal cost of $55 a barrel. Horizontal drilling, fracking, and seismic graphing of rock formation are working wonders. The cost of US shale production has fallen. For example, wellhead breakeven oil prices in Bakken, Eagle Ford, Permian Midland, Permian Delaware and Niobrara oil fields are less than $40 a barrel. Consequently, the US is setting oil production records for shale companies supported by slashing costs and large sums of borrowed money to keep drilling. The oil shale survivors are leaner and tech-savvy. Moreover, the industry is not only made up of risk-taking pioneers. Many major oil groups like Exxon and Chevron are joining the shale oil rush. Oil output is about to top 10 million barrels per day based on forecasts by the Energy Information Administration. America could become the world's leading producer in 2018. According to the IEA's World Energy Outlook, the US is set to be the dominant force in energy production for the foreseeable future. By 2025, increases in US gas and oil production will turn the country into a net exporter of fossil fuels making the U.S. the undisputed leader in the oil and gas markets. Soaring output from shell wells combined with plans to open vast ocean acreage to offshore exploration and to allow drilling in the Arctic National Wildlife Refuge is already producing a fundamental shift in the global oil complex. Changes are:

1. World prices are lower than they would otherwise be. I've seen estimates of the impact as high as $5.00 a barrel. Currently, Brent contracts are settling for $3.13 more than WTI futures. A month ago, the differential on the same contracts was $7.50.
2. Energy security has been bolstered and led to a dramatic reduction in net imports, down from a peak of 13.4 million barrels a day in 2006 to less than 2.5 million today..
3. The U.S. has lifted restrictions on crude oil exports. The U.S. is presently exporting 1.6 million bpd, mainly to China and Canada. U.S. production has flooded the markets countering declining Venezuelan production.

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4. U.S. shale has reduced geopolitical energy tension between China and the US—-two superpowers competing for oil supplies.
5. The shale revolution is replacing a market that was, until lately, dominated by mega projects of sovereigns and oil majors with long lead-in times. Now we see smaller producers that can adjust rapidly to changes in demand and price. There is potential for increased production and resiliency as producers can quickly cut costs and/or change their rig counts. This should bring about more oil price stability.
6. For OPEC, the U.S. presents an unprecedented challenge. If the oil cartel cuts production, the shale producers can respond by boosting output, stealing market share, and undermining efforts to manipulate prices. Russia could be a big loser forced into cooperation with Saudi Arabia.
7. As long as oil prices remains cheap and relatively inexpensive, there will be less incentive to carry out long-term projects and switch to cleaner energy discouraging investments in renewables such as solar and wind and electric motors.

A new world order has emerged that is proving to be good for the US on several fronts. Firstly, the influence of one of the most powerful forces of the past 50 years, the modern petrostate has diminished. The U.S. no longer needs to acquiesce to the desires of oil-supplying nations and is no longer compelled to interfere in OPEC quarrels. Secondly, the budgetary deficits of OPEC and other oil exporters participating in production cuts needs $68 a barrel for a sustainable period in order to make dents in their fiscal positions and as much as $80 a barrel to have geopolitical significance. America's energy independence is surely making Saudi Arabia nervous. Saudi Arabian exports to the U.S. have taken a tumble, falling to their lowest level on 30 years to 525,000 bpd from 1.5 million bpd a decade ago. Nervous indeed, for there is talk of Saudi Aramco partnering with Google to create a large technology hub inside the Middle East.

U.S. shale is seriously challenging North Sea crude as the world benchmark. Reuters reported a that trading desks in Chicago, Houston, and New York are very busy. A brisk business in West Texas Intermediate crude futures is far outpacing contracts for London-based Brent crude. The boom in shale production is reconnecting the US to the global markets. As global firms increasingly buy US oil, they tend to offset exposure by trading in the US futures markets giving US producers better prices and an abundance of opportunities to lock in profits. About 310 million U.S. crude futures contracts—worth about $16 trillion in oil—changed hands on New York Mercantile Exchange (NYMEX) in 2017, far more than the 242 million contracts in International Exchange Brent crude futures. It is a clear manifestation that rising oil production in the US is getting world recognition and replacing Brent benchmarks as the preferred contracts of traders, speculators, investors and commercial operators. The increased liquidity in U.S. oil futures is helping the US to reclaim its historical relevance as a world benchmarks. Currently, WTI contracts are tied to oil deliverable at the landlocked storage hub in Cushing, Oklahoma. This is changing as more supply is heading to Houston to satisfy Asian buyers and making it easier to compare spreads between WTI and Middle-East benchmarks in Dubai. Overall, refiners can better evaluate the economics of U.S. crude. We now monitor WTI crude prices more closely than Brent crude prices watching differentials between spot and future contract prices in the US markets. We find it to be a better indicator of future price movements. At the time of this writing, market activities were still somewhat bullish despite the recent price declines. The trendlines for the WTI crude-oil spot price and the five-year forward price tells us that $60 is a base making WTI crude-oil prices less subject to speculative fluctuations and better approximation of the underlying commercial supply and demand.

It is interesting to note that the big banks are embracing the late surge in oil prices. Goldman Sachs, JPMorgan and Morgan Stanley have abandoned their skepticism and accept that OPEC's output cuts are clearing the global glut. Venezuela's production problem helped. It's very heavy oil needs to be blended with higher quality oil to make it exportable. Consequently, production has fallen by 475,000 bpd. WTI oil is being bid-out of storage.

We are not as bullish as the big names on Wall Street. We are looking at a $60 to $65 price going forward. We are prudent forecasters. Investors should take note that those in the "know' like ConocoPhillips, the largest US exploration and production company, have ruled out investing in projects that need an oil price of $50 or higher to make a profit.

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