PALOS
INVESTMENT FUNDS

February 15, 2018

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# Palos Weekly Commentary

## ■ Palos Funds

*By Charles Marleau*

### The Liquor Stores Getting Ready to Distribute Cannabis

On November 30, 2017, I wrote about Liquor Stores N.A. (TSX: LIQ) and stated that the company had a significant opportunity to expand into the cannabis retail market. On February 2, 2018, Aurora Cannabis (TSX: ACB) announced that it will be buying a 19.9% stake in LIQ at a 28% premium ($15.00/share) through a non-brokered private placement. This $103.5 million cash injection has enabled the company to rid its balance sheet of debt and aggressively move forward with Canadian store renovations. This deal will allow LIQ to concentrate on the cannabis retailing opportunities. In the financing press release, the company stated that it would "launch a leading brand of cannabis retail outlets, whereby it will convert some number of LIQ's existing retail outlets into cannabis retail outlets and establish new cannabis retail outlets." Palos sees the cannabis retail opportunity to be very meaningful and ACB clearly sees this as well. Their $103.5 million cash injection represents a strong vote of confidence. LIQ is now the best positioned cannabis retailer in the Alberta recreational market with the potential for an expanded presence in all provinces.

## ■ What is New on the Macro Level?

*By Hubert Marleau*

### The Gross Domestic Product as a Measure of Economic Activity

Judging from a series of new books and ed-op articles, the gross domestic product (GDP) is history and its days are numbered. The predicted demise is based on the notion that it does not measure how bad or good the economy is doing. The Western obsession with "increase production and consumption" is ending, growth at all cost produces neglected hidden environmental price and does not bring well-being, welfare or happiness. We think that this thesis is false. Bill Clinton apocryphally said to President Bush "It's the economy stupid". GDP measures economic activity and material prosperity. How it's distributed is a function of supply and demand.

GDP is a 20th-century invention made by statisticians and economists; a statistical construct of national accounts that aggregates monetary

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

| | FundServ | NAVPS | YTD Returns |
|---|---|---|---|
| Palos Income Fund L.P. | PAL 100 | $9.81 | -3.13% |
| Palos Equity Income Fund - RRSP | PAL 101 | $6.48 | -2.93% |
| Palos Merchant Fund L.P. (Dec 29, 2017) | PAL 500 | $4.61 | 15.26% |
| Palos WP Growth Fund - RRSP | PAL200 | $10.07 | -5.54% |
| S&P TSX Composite | | | -4.69% |
| S&P 500 | | | 2.41% |
| S&P TSX Venture | | | -1.93% |

**Chart 2: Market Data***

| | Value |
|---|---|
| US Government 10-Year | 2.91% |
| Canadian Government 10-Year | 2.37% |
| Crude Oil Spot | US $61.39 |
| Gold Spot | US $1,353.20 |
| US Gov't10-Year/Moody BAA Corp. Spread | 167 bps |
| USD/CAD Exchange Rate Spot | US $0.8010 |

* Period ending Feb 15, 2018

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exchanges with the aim of encapsulating constant innovation and betterment of life, driven by competition in market economies. It's not perfect, it's a human construct. Yet, it's objective, measurable and a way to gauge growth and access the result of policies. That is why it is the king of numbers. GDP does what it is supposed to do, measure all monetized activity between willing participants throughout a quarter. As explained below, it is an unacceptable critique that is insufficient to convincingly argue that GDP will be dethroned from its top statistical billing.

- They argue that growth is delusional because of the way it's measured. That is nuts because the method of measurement does not mean that growth is bad or senseless. GDP does fail to capture the value of innovation. However, GDP is not about putting a price on innovation, that is for the stock market to determine. In any case, in the fullness of time, increases in GDP are the result of innovation. So, to be against growth is to be against innovation. It follows that those who think growth is delusional need to throw something away when a new product or service comes along to prevent GDP from growing. It's ridiculous. It is true that a lot of R&D is wasted for many times nothing good comes out of it. It's like a lottery ticket, it will enhance productivity and create value once it shows its usefulness.
- They make suggestions that GDP should be replaced with alternatives that are already in wide use and far from being a statistical revolution like GDP per capita, which tracks median income to see the distribution of gains and national balance sheet.
- They argue that GDP is not a measure of well-being. I agree. But, GDP growth shows whether a country can afford the sacrifice of paying for cleaner air, better health care or better public infrastructures.
- One big issue is that parents' housework and childcare go unpaid. Neither am I paid to ride my bike or wash my car. These are things that we do for ourselves not for monetary gains. I take a taxi to go to work, a GDP contributor. An actual drive to work is not. The inadequacies do not mean that it should be thrown overboard. Personal preferences should not interfere with GDP accounts.
- They also think that over-abundance should not be free. While, as reported by the Economist, it may be true that a 19th century billionaire would have given half his fortune for life saving antibiotics. Now antibiotics cost pennies and contribute virtually nothing to our measured economy. The argument misses the point that lower prices for antibiotics, increase the means to buy other products. Another argument, is that Wikipedia, which brings human knowledge to everyone, does not add a cent to GDP. Directly, it's true but one should look beyond that. Widespread knowledge increases productivity and thus the GDP.

The bottom line is that GDP, properly adopted and used, can be a very useful metric to devise monetary and fiscal policies, formulate economic goals and evaluate cost/benefit ratios. As a matter of fact, if one is after a measure of happiness, one may want to try the Human Development Index devised by Pakistani economist Mahbub ul Haq. It should be noted that I'm neither happy or unhappy. I, rarely, have moments of happiness. In our view, GDP is not about happiness. It will remain the most powerful metric in economic history as a solution to a multitude of problems. Enlarging the pie dominates economic thinking. It poses a challenge to those who differ and want a viable alternative for any measurement other than a rise in production. It would mean hard political decisions about what is public good; alienating one constituency or another is a major risk. The narrative that more is better for everyone is hard to deny.

I believe in the economic law of desired supply and desired demand, where prices turn the two into quantitative supply and demand and in the economic axiom that growth is a function of employment and productivity and in the common sense that innovation is the true source of material prosperity. What we do with it is a political decision. The national account does a pretty good and reliable job of matching demand (N-GDP) and supply (National Income) through price changes. Palos' investment strategies are dependent on the composition of the national account and the path of GDP to determine the right level of interest rates, stock market returns and the economic imbalances that can cause financial and societal troubles.

## The U.S. Economic Outlook

The White House's budget proposal projects that the economy, which grew 2.5% in 2017, will grow 3.2% in 2018 and around 3.0% per year over the coming decade. Many private forecasters, who also expect economic growth to pick up this year, are encouraged by tax cuts, reduced regulations and the budget deal. In December, the Fed projected GDP growth of only 2.1% for next year and a long run pace of 1.8%. The difference can

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be explained by the usual conservatism of the monetary authorities. In our view, a sustained growth of 3.0% will be difficult to achieve without a productivity boost or a reversal in the slowing expansion of the working age cohort. It should be well noted that productivity numbers have improved of late and so have employment numbers. Interestingly, many people are joining the labor force even though wage gains have been subdued. Kevin Hassett, chairman of the White House Council of Economic Advisers, said that the U.S. economy is moving from new normal to normal. Without the Administration policy changes, the economy would only grow at an annual rate of 2.2%. Thus, the implied 0.8% stimulus will have to translate into either a higher labor participation rate or higher productivity growth, otherwise the difference will end up in higher inflation. If one gives the White House the benefit of the doubt that inflation will not cross the 2% inflation target, the long-run pace of N-GDP will end up around 5.0%. We are inclined to agree because the Fed is not likely to alter its 2% inflation goal. Changing the rules could trigger skepticism and uncertainty. If indeed the pace of inflation will not be allowed to float above the accepted world-wide standard, sticking with the expected inflation anchor tells our model that 10-year Treasury yields will gradually rise toward 3.75% and that is exactly where the Administration has them.

## The Three Big Indicators: The Yield Curve, the Neutral Rate of Interest Rates and the Fisher Theory

There are many indicators to watch. Unfortunately, not every investor has the time or inclination to monitor a multitude of economic and financial data points that end up determining the path of GDP. There are three things that are essential: the yield curve, the neutral rate of interest rates and Fisherism.

Neo-Fisherism is based on the notion that the relationship between interest rates and inflation implies that low policy rates for a long period of time must mean low inflation. The original theory of interest rates indicates that the nominal interest rate can be approximated by the sum of the real interest rate and expected inflation rate with real interest rate being the independent variable. In this regard, the expected inflation rate has a unidirectional causal relationship with nominal interest rates. Put simply, only higher expected inflation rates will result in rising nominal interest rates. Strangely, since the beginning of the year, the 40 bps increase in 10-year bond yields to 2.90%, did not result from higher inflationary expectations for most of the increase was attributable to the rise in the 10-year TIPS (inflation-adjusted bond yield). One could deduct from this observation that the market anticipates a rise in productivity. It's the only way bond yields can rise without a market belief that inflation is on the rise.

According to the Bank of Canada, the neutral rate of interest is the real policy rate that prevails when an economy's output is at its potential level and inflation is at the central bank's target, after the effects of all cyclical forces have dissipated. The neutral rate serves as a benchmark to gauge the degree of monetary stimulus in place and provides a medium to long term anchor for the real policy rate. We rely on Moody's Analytics to determine the U.S. neutral rate. That number is 2.00%. Thus, the U.S. economy is 75 bps or three policy hikes away from what would be considered neutral. In other words, anything above 2.00% for three months treasury bills would be negative for both inflation and growth. At the time of this writing, these bills are trading for 1.55%.

The yield curve compares interest rates at different maturities, typically the spread between yields on two and ten-year government bonds. As a rule, ten-year bond yields reflect the market outlook for growth and inflation, while two-year interest rates reflect market expectations for Federal Reserve policy rates. There are four ways to look at the yield curve:

- When the yield curve is narrowing because monetary policy-induced short-term interest rates are rising; it's usually neutral to mildly bearish for inflation and growth.
- When the yield curve is narrowing because market-induced long-term rates are falling; it's usually mildly to strongly bearish for inflation and growth.
- When the yield curve is steepening because monetary policy-induced short-term rates are falling; it's usually mildly to strongly bullish for inflation and growth.
- When the yield curve is steepening because market-induced long-term rates are rising; it's usually neutral to mildly bullish for inflation and growth.

In this connection, the yield curve is a valuable real-time business cycle indicator. It is interesting to note that since the end of December, the yield curve has steepened by about 35 bps because of higher long-term rates, suggesting a neutral to mildly bullish sentiment for growth and inflation. It makes good sense when an economy is

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approaching full-employment on target with inflation.

The bottom line is that U.S. consumer prices rose 0.5% in January, more than expected and the largest monthly gain since 2013. Year over year, the headline CPI registered an increase of 2.1% and the core CPI rose 1.9%. While the January update did not upset the stock market, it had an impact on the bond market. For example, since the start of the year, the bulk of the increase in ten-year bond yields has resulted from the rise in inflation-adjusted yields. It's sensible for the CPI increase to coincide with several temporary factors like the unseasonably cold weather, higher global fuel prices and methodological calculation changes. If one was to factor-out these seasonal-adjustment changes, the inflation numbers would have been softer. There is a lot statistical noise surrounding the current inflation numbers. Moreover, there is a strong relationship between inflationary expectation and movements in oil prices. The spot price for crude oil is down 12% from a peak of $66 a barrel in January. Additionally, there is no guarantee that wage gains will turn into higher inflation because cost push is often absorbed by lower profit margins, higher productivity and higher labor force participation. Lastly, structural forces like globalization and technological advancements have not gone away. The market anticipates that growth for the foreseeable future will be sustained by increases in productivity and, in turn, without an alarming rise in inflation. Thus, we will slowly move toward normalization which means not more than three rate hikes by the Fed. The risk of our thesis can be hedged with some bullion or gold stocks.

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