PALOS
INVESTMENT FUNDS

April 5, 2018

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■Portfolio Management & Advisors

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Superior is Slimming Down

On April 3, 2018, Superior Plus Corp (TSX:SPB) announced $72 million in non-core dispositions. The sales included their U.S. wholesale refined fuels business and some fuel terminal assets. The dispersal of the lower margin wholesale businesses will allow the company to focus on its significantly higher retail business. Superior also sold some US retail distillate assets. The sale proceeds add to SPB's war chest. The cash generated will be used to acquire more strategic assets for their core businesses: energy services, specialty chemicals, and construction products distribution. Palos believes that the company can easily make 2 to 4 tuck-in acquisitions in 2018. The smooth integration of the Canwest Propane acquisition, with synergies likely to come in above SPB's guidance, have reinforced the company's strong integration track record. Small acquisitions with significant synergies can be very lucrative for SPB's free cash flow. The next step for management could potentially be increasing the stock's dividend.

Superior is trading at a very attractive valuation with a P/AFFO of 8.4x versus its peers trading at an 11x multiple on average. Furthermore, the company has a current dividend yield of 5.7%. Moreover, the macro environment has significant positive tailwinds. Freezing winter conditions in North America have led to strong propane demand and higher sales prices. Superior also benefited from high sodium chlorate prices and will be able to reprice its delivery contracts higher in late 2018.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.46	-3.00%
Palos Equity Income Fund - RRSP	PAL 101	$6.28	-2.93%
Palos Merchant Fund L.P. (Dec 29, 2017)	PAL 500	$4.61	15.26%
Palos WP Growth Fund - RRSP	PAL200	$9.25	-13.50%
S&P TSX Composite			-4.54%
S&P 500			0.09%
S&P TSX Venture			-9.37%

Chart 2: Market Data*

	Value
US Government 10-Year	2.83%
Canadian Government 10-Year	2.18%
Crude Oil Spot	US $63.73
Gold Spot	US $1,326.80
US Gov't10-Year/Moody BAA Corp. Spread	184 bps
USD/CAD Exchange Rate Spot	US $0.7842

* Period ending Apr 5, 2018

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■ What is New on the Macro Level?

By Hubert Marleau

The Weekly Narrative

It's interesting that many investors make important decisions based on headlines that do not focus on appropriate criteria. They either interpret the latest narratives as shortcuts to make what they think are better and faster decisions or use Excel spreadsheets with many different weight adjusted columns to suit one's desire. These kinds of decisions usually backfire as they can lead to costly signs of omission or paralyze the decision-making process. In order to avoid this problem, one needs to do some critical thinking, use valid theories, employ empirical evidence, develop "What If" scenarios, and make reality checks. When it comes to the stock market, there are three important factors to follow: the starting valuation point, the prospect for profit, and the outlook for interest rates.

The Palos Point of View

At the time of this writing, the S&P 500 was 2645, down 8.1% from its peak on January 26. The S&P 500 has suffered from two corrections and tested the 200-day moving average three times - the last two dips were more related to political concerns regarding Trump. His non-stop threats are annoying the market and weighing on sentiment. Protectionist proposals and attacks on individual companies are not eagerly supported by many corporate leaders. So far, the "Maginot Line of Defense" is holding better than it did during the Second World War. Technically, the markets should improve from here on. Unfortunately, the escalating tit-for-tat trade dispute with China is turning into a digital war. It is said that the two countries are about to enter a period of negotiations in the hopes that they can hash out a deal and bring back some rationality to the market. We trust that Larry Kudlow, National Economic Council Director, is right that Trump's bluster is part of a negotiating strategy to win better trade terms. Kudlow is not stupid. He knows that he cannot leave trade as an open-ended issue and wants to solve this with the least amount of pain. I know Kudlow from his days at Bear Stern, he knows that low trade barriers are good for the economy.

The Palos Rationale

The twelve month trailing EPS for 2017 is $126.35 and the P/E ratio is 20.9 for an earnings yield of 4.78% that is 200 bps above ten-year treasury yields (2,78%). Admittedly, 200 bps looks expensive. History shows that when the Rule of 20 (when the P/E multiple (20.9x) plus the year-over-year increase in the CPI excluding food and energy (1.80%)) is above 20, troubling volatility lies ahead. Valuations and Inflation are worrying investors right now. It explains why a lot of money was recycled into the Treasury market. It's the fear that a more aggressive Fed could create havoc with valuations, at least temporarily. Yet, when one takes into consideration the Misery Index (the inflation rate plus the unemployment rate), the PEG ratio (P/E divided by N-GDP growth) and the Fed model, the market situation is not as bad as you might think. When things get rough, it's best to batten down the hatches and ride out the storm. When one looks at volatility alone as opposed to the surprise of having volatility in the first place, such episodes are not unprecedented. History is clear that if one bails out of the market too soon, it can be very costly in a nominal 2% interest rate world. The facts show that those who sold after Brexit, the U.S. election, or any of the five corrections since 2009 (that look just like what we are going through now) must now regret their decisions. The risk of missing out can be more expensive than waiting endlessly for a bottom. As data compiled by BAML shows, the penalty an investor incurs by sitting out the biggest single-day gains in the market are immense. Cambria Investment Management found that missing the 200 best days between 1928 and 2010 cut annual returns in equities from 4.9% to minus 7.1%.

Indeed, the situation is not frightening when one is willing to look over the horizon. EPS growth will be strong in 2018 and 2019 because the economy is moving ahead at a steady pace and the GOP tax cuts are large. The economy should produce EPS of $157 in 2018 and of $175 in 2019. These numbers are solid for there are no indications at this time that margin compressions based on either increased input costs or decreased selling prices are in the cards. N-GDP and producer prices are increasing considerably faster than unit labor costs and hourly wage rates. Down the road, valuation metrics will look a lot better and be more in line with the current business cycle and secular trends. Since 1993, the S&P 500 generated an accumulated return of 1103.2% compared to 1191.7% for dividend and earnings growth. Top down and bottom up analysts calculate that 2018 and 2019 P/E multiples are 16.5 and 15.0 respectively, moving the 2018 and 2019 earnings yield to 6.05% and 6.75%, and giving a respectable 2018 ERP of 330 bps and an

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alluring 2019 ERP of 400 bps. ERP stands for equity return premium - the extra return that stock investors want over a riskless rate of interest. According to JPMorgan, companies are on pace to execute more than $800 billion in gross share buybacks as soon as the current lockup period ends in two weeks, a crucial backstop for stock prices.

There will be a point in time when forward earnings will become the trailing earnings and valuations are going to look pretty attractive. The question is whether the market should serve the present situation of overblown valuations or reflect the future potential of reasonable metrics in the future. Evidently, the market has had a difficult time making up its mind in explaining the recent bout of volatility resulting from trade issues and problems with the FAANG stocks. The S&P 500 moved up or down 1% or more on 27 separate occasions since the start of the year. Speculators want proof that the future will not be negated by a coming recession brought about by a overheated economy. Overheated economies are the product of too much inflation accompanied with higher interest rates. In our opinion, as long as the rate of inflation does not overshoot the Fed's 2% inflation target by too much, the policy rates will stay below the 2.5% natural rate, the yield curve will not invert, and long-term bond yields will not cross the pace of the N-GDP. The bullish profit scenario will conquer. An important takeaway from the first quarter is that investors were afraid, thinking that signs of firmer inflation could upset the "Goldilocks" narratives that have underpinned the secular bull trend. If inflation was to remain well-anchored around 2.0%, it becomes difficult to build a thesis that there could be a perilous rise in the policy rate above the 2.50% natural rate. Under this scenario, long term bond yields would not cross the crucial 3.00% level and the yield curve would not dangerously invert. We understand why every future data point will be scrutinized for signs of upwards price pressure. Palos is not worried. So far, we have only had weak signs of inflation. The U.S. core CPI increased 1.8% in February compared to an average of 2.0% in 2016. The average hourly earnings increased 2.6% in February for a real wage growth of only 0.8%. Unit labor costs were up 1.7%. Additionally, in February, the Fed's preferred price index, the core PCE index, was only up 1.6% over the last twelve months. It should be noted that inflation is a monetary phenomenon. Wages do not cause inflation. Both prices and wages rise in response to an increase in aggregate demand, which is a function of the Fed's monetary stance. In this regard, inflation does not look scary. The money supply is rising only fast enough to support a 4.0% annual increase in N-GDP. MZM (transactional money with zero maturity) is up only 4.1% in the twelve months ended March 2018. To have a surge in inflation, the velocity of money needs to rise. It has not risen since 2000 and there is no sign that it is about to do so. It is also interesting to note that the additional economic output (GDP) generated by each additional dollar of business debt is decreasing. It now takes $1.39 of debt to produce $1.00 of economic activity; in 2002, it took $1.82. It shows that the debt-growth ratio is not as inflationary as it used to be. As a matter of fact, core inflation has stayed in a relatively narrow band between 1.0% and 2.3% for an average of 1.75% for 23 years. The tight labor market and the fiscal stimulus are the only reasons why we see cyclical inflation rising to the top of that 23-year band. One might think that our view on inflation is moderate given the tighter labor conditions. So far, all rebounds in wage pressures have been partially muted by rising labor-force participation or productivity. A study produced by UBS suggests that inflation does not really start to rise until the unemployment rate hits 3.7% and does not accelerate until a 3.3% rate is reached. Even then, it can take a few years to show up.

The bottom line is that the lack of inflation is the main reason why valuation metrics look stretched. Looking forward, some of the headwinds facing the market may vanish when earnings seasons comes around next week. The typical winter slowdown will turn, the Fed might realize that it should rethink its monetary stance in light of the narrower yield curve, and Trump may calm down as the midterm elections approache. While we are aware that it is not normal for the market to go up in a straight line and the speculators may want to retest the defense capability of the 200-day moving average, Palos is holding on to its reflation basket of stocks. It's not that we are inflationary pessimistic, but because a regime of 2.0% to 2.25% is what the monetary authorities want,even if none are prepared to admit as much. Two percent plus inflation would create a return to normality, seemingly destroy public debt, and lift a huge pension burden off of government's shoulders. This could work quite well for debt holders as these structural forces should prevent interest rates from crossing the crucial level of 3.00%.

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