Issue 10

PALOS
INVESTMENT FUNDS

March 9, 2017

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

Hardwoods Distribution

Hardwoods Distribution (TSX:HWD) is a leading distributor of high grade lumber products in North America. Its goal is to be the link between large suppliers and smaller industrial manufacturers (IM). Without hardwoods' distribution network, the large suppliers would not be able to service the smaller IMs. Harwoods has created a hub and spoke network via its 60 facilities across North America.

HWD gets 90% of its revenues from the US and 10% from Canada. The end users of HWD products can be broken down into three segments: residential (52%), commercial (36%) and other (12.5%). Prior to its acquisition of Rugby Architectural Building Products on June 2016, a larger proportion of the company's revenues were attributed to the residential segment, which is more volatile.

The acquisition was strategic as it brought diversification and further exposure to the US. The commercial exposure has significantly de-risked the company as it's a faster growing and less volatile market.

HWD should trade in-line with its peers, if not at a premium, as its strategic acquisition gets fully integrated and continues to organically grow above 10%. HWD is trading at 7.5x EV/EBITDA 2017 and 7.3x EV/EBITDA 2018 compared to the group average of 10.4x and 8.5x respectively. In addition, its debt level for 2017 is very manageable at 1.1x Net Debt/EBITDA 2017. We are expecting the company's debt level to further fall in 2018 and dividends to significantly increase.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.74	-0.18%
Palos Equity Income Fund - RRSP	PAL 101	$6.39	0.24%
Palos Merchant Fund L.P. (Dec 31, 2016)	PAL 500	$4.33	-16.73%
Palos IOU High Yield Fund (Feb 28, 2017)	PAL 701	US $7.37	-1.23%
Palos WP Growth Fund - RRSP (Mar 7, 2017)	PAL200	US $9.67	-3.28%
S&P TSX Composite			1.81%
S&P 500			6.07%
S&P TSX Venture			3.50%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			2.34%

Chart 2: Market Data*

	Value
US Government 10-Year	2.61%
Canadian Government 10-Year	1.81%
Crude Oil Spot	US $49.62
Gold Spot	US $1,200.90
US Gov't10-Year/Moody BAA Corp. Spread	216 bps
USD/CAD Exchange Rate Spot	US $0.7401

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■ What is New on the Macro Level?

By Hubert Marleau

The U.S.Trade Balance

The February trade balance, a key economic data point, had its largest monthly deficit in years. It registered a deficit of $48.5 billion. In real terms, the deficit widened to $65.3 billion. Fortunately, the bond and stock markets don't pay much attention to trade balance prints and investors are usually indifferent to them. It is possible that the numbers were skewed due to the Chinese Lunar new year. Nevertheless, we believe rising international trade deficits will lead to softer GDP figures, lower economic optimism and a tighter monetary stance. The following three points show further evidence of this:

1. The Atlanta Fed GDPNOW model forecast for the first quarter GDP growth just fell to 1.3%. It was 3.4% a few weeks ago and significantly lower than Washington's optimistic 4% target.
2. Business confidence may have peaked as a result of this latest print on trade as it supports the Border Tax Adjustment idea. The US IBD/Tipp, a measure of economic optimism, fell to 55.3 this week from 56.4. The expectation was 57.1. The University of Michigan consumer confidence index has also decreased.
3. While we recognize that monetary policy is officially a function of where the current 2.5% inflation rate is vis-à-vis the 2% target rate, and where the current 4.7% unemployment rate is vis-à-vis the 4.5% full employment target, the viability of the trade balance can also play an influential role in the decision-making of the monetary authorities. The increased trade deficit boosted the Palos Monetary Policy Index to 175 from 161 last week, increasing the odds that the Fed will hike the Federal Funds rate another 0.50% next week.

Moreover, trade deficits were a prominent issue during the 2016 presidential campaign and President Trump pledged to make the nation's commercial relationships more balanced. He has made free and fair trade a central part of his agenda in the hope of correcting international imbalances. Easing the US trade deficit will be a daunting and difficult task as the US has large trade gaps with several countries like China, Mexico, South Korea, Japan and Germany, which have been in existence for decades. Depending on the course of action taken by the US administration, currency manipulation, a lower standard of living, a decrease in the comparative advantage of specialization at work, trade wars and protectionism may ensue. None of which is good for globalization, international cooperation and corporate business.

U.S. Productivity

As we have often argued in past commentaries, U.S. productivity growth is improving. The Bureau of Labor Statistics reported that during the fourth quarter of 2016, productivity rose at an annual rate of 1.3% and 3.3% in the third quarter of 2016. On a year over year basis, productivity increased 1.1%, much better than the negative performance of previous quarters.

The Employment Situation

The ADP National Employment Report showed that private non-farm payrolls rose 298,000 in February. This could bring back the projected increase in real GDP, for the first quarter of 2017, to 2.0%. We will have to wait and see on this one. The BLS will print the employment situation for the month of February on Friday.

The Value of the U.S. Stock Market

Stock prices can be considered fairly valued when they reflect investors' expectations for earnings growth, interest rates and energy prices. Moody's Analytics calculates that fair value for the S&P 500 is 2490. We are however cautious. Assuming that nominal GDP will increase about 4.0% over the coming year, that the appropriate discount rate is 7.0% and that oil prices will be range bound between $50 and $55, we estimate that the fair value is closer to 2205. On Thursday morning, the S&P 500 futures were trading around 2265.

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