Issue 13

PALOS
INVESTMENT FUNDS

March 30, 2017

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Palos Weekly Commentary

■ Palos Income Fund
By Charles Marleau

CanWel Bulding Materials 2.0

We had the chance to meet with CanWel's (TSX:CWX) management team and was pleasantly surprised by the company and its future opportunities. CWX distributes building materials and is a provider of logging and wood-treatment services via 10 facilities in Canada and the United States. CWX has four divisions:

1. Building Materials
2. Treating Division
3. California Cascade
4. Forestry Products

The first two divisions represent the legacy business of CWX and are mostly driven by the Canadian Housing market. CWX has completed two acquisitions which has diversified its revenue away from being a pure play on the Canadian Housing market. The California Cascade acquisition provided the company with Western United States exposure which is driven by the housing market as well as by commercial activity. The last acquisition made was under the forestry products division and it allowed CWX to become vertically-integrated. In addition, the acquisition was done using a distressed evaluation as the creditors were in the driver's seat.With the two latest acquisitions, CWX margins have improved and we believe they will continue to significantly as CWX integrates the distressed forestry product company they acquired (Jemi-Fibre). If CWX successfully integrates Jemi-Fiber, the company could achieve EBITDA margin of 6%. If successful, the company should start trading at a higher multiple.

In addition, the company was historically levered. In 2015, for example, CWX traded at a 5.0x Net Debt/EBITDA and we are expecting this to fall to 2.1x in 2017. We also see a continuation of its payout ratio falling to 80% of free cash flow in 2017 which is a long way from the 120% payout in 2015. The management of CWX has also reassured us that increasing its dividend is not in their plans which we think is best, especially since the stock is already yielding 9.23%. CanWel's Management left us with three main focal points: margin expansion, further reduction in payout ratio and additional revenue diversification via acquisitions. We believe the management team

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.89	1.36%
Palos Equity Income Fund - RRSP	PAL 101	$6.47	1.43%
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 28, 2017)	PAL200	US $9.80	-2.04%
S&P TSX Composite			2.57%
S&P 500			6.31%
S&P TSX Venture			6.02%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			2.37%

Chart 2: Market Data*

	Value
US Government 10-Year	2.42%
Canadian Government 10-Year	1.64%
Crude Oil Spot	US $50.33
Gold Spot	US $1,241.50
US Gov't10-Year/Moody BAA Corp. Spread	224 bps
USD/CAD Exchange Rate Spot	US $0.7495

* Period ending Mar 30, 2017

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has matured and that they have their priorities in the right direction.

■ What is New on the Macro Level?

By Hubert Marleau

U.S. Corporate Profit

According to FactSet, the U.S. companies included in the S&P 500 are expected to report a year over year after-tax profit increase of 9.1% in the quarter ending March 31st of 2017. If the estimate holds up, it will be the third consecutive quarterly increase and the best run since the last quarter of 2011. Stocks are trading near record highs and valuations are rich. They are however not bubbling. Earnings are considered the most important valuation metric and rising profits are necessary to support valuations. Another key metric is long term interest rate as declining bond yields can be helpful. Interestingly, the cost of money is rising but the cost of capital is not. Investor sentiment in the treasury market has turned bullish. Many foreign investors and foreign officials have pushed down bond yields with large purchases. In this respect, the discount rate is still attractive despite the fed's intention to raise the federal funds rate.

Fair Value of the S&P 500

It appears that the stock market is undergoing a long-awaited correction as the hope for progress on tax reforms and regulations, before the summer recess, appears to have vanished. In our judgment, the post-election rally has driven the S&P 500 up too much and has separated stock prices from their underlying fundamentals. History suggests that corrections, in the absence of consumer confidence and recessions, tend to be very short but sharp, with much of their losses recovered very quickly. Firstly, there is little evidence that the expansion is in serious jeopardy or that it will end anytime soon. Moody's Analytics calculates that the probability that the U.S. economy will fall into a recession in the next six months is only 6%, an historical low. Secondly, the Conference Board Consumer Index is 125.6, the highest level since the financial crisis. Under such conditions, only a pullback from the March high of 2395 to 2225 is possible. Thirdly, the CBOE Skew Index, which measures the bets taken on tail-end occurrences, shows very moderate probabilities of a black or white swan event.

Overall, the correctional effect is related to the market's unease over whether Trump can in factdeliver. The good thing is that it is deflating pockets of froth and creating buying opportunities for those still on the sidelines. It makes investors feel more secure about future returns. Acknowledging that picking bottoms is hardly possible, a seasoned investor could start adding stock exposure when the S&P 500 reaches 2275. Since fund managers are not overly exposed to equity markets, any pull back in stocks is going to be met with renewed buying. One should keep in mind that data points are generally pointing to improving manufacturing and economic sentiment across the globe as a sign that growth prospects are unwavering. Global business sentiment remains strong and has risen from 33.8 to 34.1 in the week ended March 24. These are good reasons to believe that the stock market will keep rising. Moreover, Moody's Analytics are suggesting that the fair value of the S&P 500 is 2500 and Merrill Lynch thinks that it could be as high as 2600. Of course, this is based on Trump's planned tax cuts, which would be a bullish game changer. If the nominal tax rate was dropped to 20%, it would boost the EPS for the S&P 500 by $13 in 2018. The increase would make stocks cheap and form a catalyst for rising stock prices. Understandably, the Border Tax Adjustments could get in the way. While it seems to be losing some appeal, the politics that surround this issue must be watched closely.

Cape Fear

The bulk of the anxiety seems to be connected to Shiller's cyclically adjusted price to earnings ratio which is admittedly high. Yet, it has been high for years and nothing has come of it. As a matter of fact, the ratio is being increasingly discredited. It's more like a white ghost that is believed to be about, but far from, materially real. The inverse of CAPE represents a yield of 3.50%, above the 2.35% yield on ten-year government bonds. The big question is whether reflation will take place. Increasing the target policy rates in the absence of increasing growth is not very promising for higher long term rates. There are three interest rate scenarios. If the target inflation rate stays at 2.00%, a real growth rate of 1.00% would produce ten-year bond yields of 2.50% or less, with 2.00% growth, ten-year bonds would yield no more than 3.00% and if growth was to rise to 3.00%, bond yields could reach 4.00%. As usual, earnings growth and interest rates will decide the 2017 outcome.

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