Issue 18

PALOS INVESTMENT FUNDS

May 04, 2017

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

Savaria keeps on buying

Savaria Corporation (TSX:SIS) designs, manufactures, and distributes equipment that facilitates the mobility of people with special needs. More information can be found on their website: https://www.savaria.com/products The North American demand for this kind of equipment is on the rise. The US and most G7 countries have growing aging populations and they are also seeing increases in disabilities among younger age groups as obesity continues to rise. We believe that SIS is well-positioned to meet the growing demand for mobility equipment. In the United States, one out of every five adults has some kind of disability. The Center for Disease Control and Prevention published a research report stating that the most common functional disability is a mobility limitation. This is defined as having serious difficulty walking or climbing stairs. We believe that SIS is well-positioned to help with this crisis.

SIS continues to grow organically, but it's also making acquisitions that are complimentary to its existing business. On May 1, 2017, SIS announced that it was acquiring Span-America (NASDAQ:SPAN) in an all-cash transaction of approximately US$80.2 million. SPAN manufactures and markets therapeutic support surfaces and pressure management products for the medical market. Please see their website for more information: http://www.spanamerica.com. According to SIS Management, the acquisition delivers three key benefits:

- It adds complementary products to SIS' roaster.
- It will provide SIS with a new distribution channel for the institutional and governmental markets.
- It will further increase SIS' presence in the US.

The acquisition will help SIS achieve its long-term growth objectives of achieving $500 million in revenue within five years. The acquisition will also bring up SIS' US presence to 50%. We are pleased with the acquisition as we see this as solidifying the company's long-term objectives.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.62	0.58%
Palos Equity Income Fund - RRSP	PAL 101	$6.35	1.18%
Palos Merchant Fund L.P. (Dec 31, 2016)	PAL 500	$4.33	-16.73%
Palos IOU High Yield Fund (Mar 31, 2017)	PAL 701	US $7.17	-1.40%
Palos WP Growth Fund - RRSP	PAL200	$9.70	-1.61%
S&P TSX Composite			1.61%
S&P 500			7.42%
S&P TSX Venture			1.73%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			3.45%

Chart 2: Market Data*

	Value
US Government 10-Year	2.35%
Canadian Government 10-Year	1.54%
Crude Oil Spot	US $45.46
Gold Spot	US $1,228.40
US Gov't10-Year/Moody BAA Corp. Spread	224 bps
USD/CAD Exchange Rate Spot	US $0.7274

* Period ending May 4, 2017

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■ What is New on the Macro Level?

By Hubert Marleau

On the U.S. March Quarter GDP: Off to a Slow Start

In the first quarter of 2017, the U.S. economy's output grew at its slowest pace in three years. R-GDP rose at a seasonally adjusted annual rate of only 0.7%. Furthermore, the rate of increase was about one third less than the typical 2.0% since the financial crisis. This is due to sluggish consumer spending, particularly on big ticket items, rising inflation and inventory drawdowns. It should be noted that business investments did particularly well, growing at a 9.4% annual pace, thus reflecting the bullish sentiment of business. However, the slowdown contrasted with rising stocks prices, declining long term interest rates and strong soft data surveys. There is consensus that the economy will rebound at an annual rate north of 3% in the quarter ending June 2017.

We like to look at the results on a year over year basis as it eliminates lumpiness and seasonal distortions. On this basis, the GDP in nominal terms is up 4.0%. The increase resulted from a 1.0% increase in employment, a 0.9% increase in productivity and a 2.1% increase in inflation. From a monetary standpoint, the growth in money supply was the main cause of the increase in the level of economic activity. It rose 5.8% while its turnover continued its long downhill march, decreasing another 1.8%. Assuming that recent GDP and monetary data is the new trend, long term interest rates should increase, but not as much as we thought three months ago. Our forecast is now 2.75% by year end. The fact is that inflation is not rising fast enough for panic to ensue.

The economic expansion has lasted nearly eight years and it has been remarkably stable. Despite its old age, the odds that a recession will occur are low. Americans have been in a two plus two economy; two percent for growth and two percent for inflation. Yet, there is a fair chance that the economy may break away from that trend since the inflation rate is around the Fed's 2% target and productivity gains are ensuing. As a matter of fact, the economy has registered three sequential quarterly increases in productivity. As a result, the economy is exactly where the Fed wants it. Policy uncertainty is somewhat elevated but there is no immediate or apparent economic cost. Consumer and business sentiment indices are near record highs, supporting the expectation that the ordinary pace of real economic activity may move up to 4.0% in the next two quarters.

On Canadian Household Debt: Bad but Passable

On average, Canadians save about 5.8% of their personal disposable income. However, more than 100% of their savings seem to be going directly or indirectly into residential construction. Currently, Canadians are saving about $70 billion a year and spending approximately $145 billion on residential structures. It's a big imbalance. It's not surprising that the real estate sector has been the strongman of the Canadian economy for the past two years. Canada's housing sector, particularly in Vancouver and Toronto, is fueling growth. For example, the real estate sector grew 5.3% in real terms in February. Because of this concentrated activity, the level of household debt is recording absolute highs and relative highs to N-GDP. The advent of Home Capital's financial problems signals caution as it puts into question the possible stress on the mortgage market and, in turn, the sustainability of long term growth. In this connection, the Bank of Canada may further reduce its growth outlook for the second half of 2017 and 2018. At this time, household debt levels appear to be well collateralized with hard and financial assets and household debt seems to be well serviced by personal disposable income. This explains why credit scores for the average Canadian are holding up. Unfortunately, Canadians may face substantial financial woes if rates or unemployment rise or if asset prices fall. My new acquaintance, Jared Dillian, in his latest daily Dirtnap, correctly pointed out that "people consistently underestimate contagion effects".

On the Global Oil Complex: The Long Term Looks Better Than the Short Term

The EIA is raising fresh concerns about the potential for a petroleum shortage as soon as 2020. Global oil discoveries fell to a record low in 2016 resulting in the fewest new conventional oil projects being sanctioned since the 1940's. Oil discoveries declined to 2.4 billion barrels in 2016 compared to an average of 9 billion barrels between 2000-2015. Investors should not rely on U.S. shale producers to save the market. Production is expected to grow by 2.3 million barrels a day over the next five years. That is unfortunately not enough to make up for the declining output elsewhere. To meet rising demand and offset underlying declines, the industry needs to produce around 18 billion of new resources each year between now and 2025.

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This can only happen if oil prices creep up to its marginal cost. A new study by MRB Partners argues that "oil producers' long term motivations can be understood in terms of three broad challenges. Oil producers must cope with the shortening life expectancy of their reserves at the same time as being buffeted by simultaneous shocks of global warming and the technological revolution associated with shale oil. The combination of these three challenges suggests that long-term policy frameworks will increasingly be de-prioritized in favor of short-term revenue-maximizing considerations". Consequently, until evidence comes through that the current supply overhang is decreasing and that the supply-demand equation rebalances, it is unlikely that oil prices will match the marginal cost of producing a barrel or reflect the aforementioned long term outlook. In this connection, Opec must extend cuts in oil output when its ministers meet on May 25. They also need to limit production until the end of 2018 because the market is already pricing an extension to the output-cut deal. Many analysts agree that if the major producers do not agree to extend the 1.8 million barrels a day limit, oil prices would have to fall to $40 to clear the market. U.S. demand has been soft, the Saudis are becoming less dependent on oil and the overhang is persistent. These developments are making speculators nervous. It may be advantageous to closely watch the evolution and formation of the contango curve. Especially the difference in spot and four-year contract price. At the time of this writing, the spot price is $47.50, $8.15 less than the four-year contract price. The spread may need to be much lower to technically drive oil prices up to where they ought to be.

On U.S. Corporate Profit: Accelerating Growth

The current earnings season is very good. The Bank of America tallies the proportion of companies beating both earnings and sales and the number is pacing to be the best in 13 years. According to data compiled by Bloomberg, not only is double digit earnings growth back, but accelerating. Thomson Reuters' estimated EPS growth for the S&P 500 has risen from 10.9% at the beginning of April to 11.3% at the end of April and is now 12.5%. For 2018, bottom up surveys show that the S&P 500 EPS should be around $138.00. In this connection, earning yields are 5.78%; 345 bps higher than 10-year treasuries. Should the gap between soft sentiment surveys and actual hard data narrow in favor of the surveys and political uncertainties do not worsen, the S&P 500 could break out. Moody's analytics assumes that the fair value of the S&P 500 is 2501. We conservatively calculate the fair value to be 2310.

On the U.S Yield Curve: Predicting Recessions

There has been quite of bit of concern in the public press that the Fed's path to normalization, at a time when the recent upticks in the rate of inflation has not turned into an established upward trend, may bring about a flattening of the yield curve. This explains why investors are scrutinizing gauges of monetary and economic conditions. On the monetary side, the rate of expansion in the money supply has decelerated a lot since the start of the year and the velocity of money continues to trend lower. On the economic side, recent economic data has been coming in below the expectations of forecasters. The anxiety is legitimate for there has never been a recession without a flat or inverted yield curve. In isolation, the shape of the yield curve (ten-year treasury yields minus two-year treasury) is usually wrong, but combined with the one year performance of copper prices and the position of the real cost money, the shape of the yield curve is a lot more predictive. Firstly, copper prices are about 12% higher than they were a year ago and the real rate on Federal funds is negative at 125 bps. It should be noted, however, that the red metal has been under downward pressure in the last two weeks. Secondly, high frequency economic models like GDP are now pointing at 3.8% to 4.3% growth for the second quarter of 2017.

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