Issue 19

PALOS
INVESTMENT FUNDS

May 11, 2017

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

Hardwood Delivers (Part 2)

A few a weeks ago, we wrote about a company called Hardwoods Distribution Inc (TSX:HWD). HWD is North America's largest wholesale distributor of architectural grade building products for the residential and industrial construction markets. The reason we have decided to do a follow-up piece on HWD is because it reported eye-popping quarterly results, which were well above ours and the street's expectations. The company achieved a record revenue, profit, and EBITDA for the first quarter of 2017. We are very pleased with the results. We believe it is very important understand the attribution of the company`s performance. After digging into the financials, the big highlights are:

- The company's organic growth increased by 8.6%, or $13.6 million.
- With acquisitions, the company grew by 63.3%, or $257.1 million.
- Gross profit grew by 72.2% to $48.3 million and gross profit margin increased to 18.8%, from 17.8%
- First quarter EBITDA climbed 48.4% to $14.0 million.
- Gross profit margin increased to 18.8$ from 17.8%.
- Diluted profit per share grew by $0.10 or 37%, to $0.37 per share.

In conclusion, we are delighted with the robust organic growth across both countries and expect it to continue for the remaining quarters of 2017. HWD is well supported by its market fundamentals and its M&A pipeline; given how fragmented the space is. HWD's balance sheet is also well capitalized to make accretive acquisitions.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.80	2.51%
Palos Equity Income Fund - RRSP	PAL 101	$6.45	2.80%
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	$9.93	-1.61%
S&P TSX Composite			2.69%
S&P 500			7.74%
S&P TSX Venture			3.61%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			3.49%

Chart 2: Market Data*

	Value
US Government 10-Year	2.39%
Canadian Government 10-Year	1.60%
Crude Oil Spot	US $47.82
Gold Spot	US $1,225.00
US Gov't10-Year/Moody BAA Corp. Spread	222 bps
USD/CAD Exchange Rate Spot	US $0.7301

* Period ending May 11, 2017

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■ What is New on the Macro Level?

By Hubert Marleau

The U.S. Stock Market

I spent a lot time reading, thinking and writing about what we need to do to achieve returns in excess of the normal stock market returns. I have found that managers that have good track records are those who have a long-term investment horizon. Unfortunately, implementing an investment strategy requires a lot of discipline, and without empirical and theoretical based rules, it’s almost impossible to accomplish. Money managers that simplify complexity and bring things down to the level of the lowest common denominator, are the winners. Mechanical and mathematical models can make beating average market returns easier if coupled with insightful human judgement. Indeed, the market works over the long term but it does possess a behavioral component. This is why seasoned investors, that are mostly successful, incrementally tweak, adjust, rotate and/or hedge their portfolios of long-term investments to fit emerging secular trends, changing valuation metrics, different market confidence and potential tipping points. Acknowledging that these forces vary over time, long-term investors, that follow and study the path of these factors, are the ones who outperform.

Secular Trends

Since 1877, there have been 11 secular trends. Five bears and six bulls. While there are no hard rules that dictate how long or how far bull or bear markets will go, history shows that, despite radical uncertainty, trends stay in a relatively predictable channel. From the lows of 2009, the S&P 500, adjusted for inflation, is up 175%. All other bull markets for the period under review were up a lot more; ranging from 266% to 666%. Additionally, we have been in a bull market for 8 years. All bull markets have lasted much longer than that, except one. This begs the question of whether tipping points are emerging. Extra returns are rare if broad turning points are left behind. That is why we recurrently ask if productivity, demographics and monetary policy are turning a corner and creating new structural mega trends. A few questions to consider:

- Are workers about to be replaced with robots and artificial intelligence?
- Are productivity dividends stemming from disruptive information technology, transformative advances in communications and huge progress in biosciences about to be widely diffused and used?
- Will the retiring baby boomers take down the stock market in the coming years by rebalancing from stocks to bonds?
- Will pure quant models, with massive computing power and promising precision, flood certain sectors with massive amounts of monies driving prices to unsustainable levels and create panic?
- Has the debt super-cycle ran its course?
- Will the political and economic power of the middle-class end?
- Will East Asia become the new power house of the world economic and monetary order?
- Will income and wealth inequality reverse?
- Next to money, nothing is more important than energy. Is a new energy regime upon us as environmental issues become too important to neglect?
- Will geopolitical uncertainties turn the world upside down?

While the future of investments is dependent on answers to these questions, it is amazing how little time is allocated to analyzing these major possibilities. The incorporation of these major investment themes, as well as others not mentioned here, is crucial to achieving superior returns.

Fundamental Valuation Metrics and Market Confidence

Investors should not overlook metrics and market sentiment since accurate measures of these can also enhance excess market returns. While short term cyclical considerations should not change one’s basic long term strategy, varying exposure to risky assets by increasing the cash component of one’s portfolio can bring interesting results. It should be noted that short term cyclical trends are mainly behavioral in nature, but can be very powerful. In this connection, it important to acknowledge two undeniable facts. Firstly, we know that P/E multiples over the long-term have averaged around 15.5 times and earning yields averaged around 6.50%. Currently, the average P/E multiple is 18.5 times, suggesting, in isolation, that the market is overvalued by about 20%. But, is it? Maybe not. On average ten-year treasury yields have centered around 5.00%, indicating that the normal gap is 150 bps. At the time of this writing, the spread is considerably wider at 300 bps. In the early 1980s, the Securities and Exchange Commission instituted a new regulation that allowed corporations to repurchase their shares in the open market. They became known as buy-backs. When combining dividends

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and buybacks, shareholders achieve a very attractive average yield of 5.25%. Secondly, we know that there are no bear markets without a recession. The factors that lead to recession are high levels of financial stress, an accumulation of too much inventory, policy mistakes and rising inflationary pressure. In this regard, we closely monitor changes in the yield curve, real rates and copper prices. A bad mixture, like a narrowing spread between ten-year treasury yields and the three-month federal funds rate combined with rising real rates and declining copper prices, can increase recession risks. A good recipe, like a widening yield curve combined with declining real rates and rising copper prices, decreases recession risks. Presently, the yield curve is narrowing at a time when copper prices are falling but from a high peak and real rates are rising but still negative. Accordingly, some caution is warranted even though many economic agencies are reporting very low probabilities of an imminent recession and most high frequency economic models are predicting a major economic uptick in the second quarter of 2017. Nevertheless, our money managers are maintaining a larger amount of cash in their portfolios than they usually would.

Monetary Policy

Another good place to look for signals of possible outcomes and to set correct expectations is the Federal Reserve. We know five important things about the Fed’s views and objectives. Firstly, the monetary authorities want to normalize the monetary stance. It means that they are favoring a few more interest rate upticks in 2017. Secondly, the Fed wants to reduce the size of its balance sheet by selling government bonds. This will bring about a major shift in the capital markets. Thirdly, the Fed has the economy just about where it wants it (price stability and full employment). Fourthly, there is awareness that the unemployment rate has dropped below its natural equilibrium, which could overheat the economy. Lastly, the productivity curve has turned for the better and its pace is slowly accelerating. On this last point, R-GDP to Employment ratio turned the corner during the third quarter of 2016. Compared with a year ago, it’s up 1.2%. Miserable, but better than what was registered before the productivity turn in the middle of 2016. As a matter of fact, financial crashes are usually followed, after a seven-year long lag, by spectacular outbursts in innovation. If high frequency economic models are right that real growth will top 3.0% in the June quarter, more ambitious productivity gains will print. It could not have come at a better time as the labor market is at full capacity. The long-term trend suggests that modest job growth is here to stay reflecting full employment. Assuming a steady labor-force participation rate, the economy needs to add only 107,000 jobs per month over the next year to keep the unemployment rate at 4.5%. If one was to use the Fed’s full employment number of 4.7%, only 82,000 jobs would be needed to stay even. If our hypothesis that productivity is on the rise is correct, the inflationary wage pressure, that usually accompanies tighter labor markets, could be halted and economic growth could regain vigor. For the longest time now, productivity has been hiding in emerging countries, low tax jurisdictions and in lower domestic retail prices. In conclusion, a lot will depend on the policy intentions and actions of the monetary authorities. At this point, Goldman Sachs’ economic model shows that the probability of a recession in the next nine quarters is low but slowly rising. The number is 31%. Recessions occur when the chances rise above 75%. The Goldman economists believe that to keep risk from rising further, the Fed needs to carefully engineer a slowdown of output growth below the past pace of 2.0%. This means two to three more interest rate increases.

P.S. Mr. Michaelson, the CEO of Michaelson Capital Partners, wrote an interesting piece in the WSJ on why productivity is about to massively increase and bring about decades of high growth. Basically, he argues that technology to date has been concentrated in the consumer sector. He thinks that this is about to change for the better since a colossal super cycle of innovation in enterprises has just begun. Please email me at hmarleau@palos.ca if you would like a copy.

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