PALOS
INVESTMENT FUNDS

May 12, 2016

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

A Good Night's Sleep

As the largest mattress retailer in Canada, Sleep Country Canada Holdings Inc. (TSX:ZZZ) operates through 225 stores and 17 distribution centers across eight provinces. Having opened 88 stores since 2007, the company continues to grow its footprint—both organically and faster than the industry itself—all while stealing market share from competitors such as Sears Canada and independent retailers.

Already, the Sleep Country brand represents 24% of the Canadian market excluding Quebec, and Dormez-Vous has hold of 17% of the Quebec market. Moreover, the company recently reported a Q12016 same-store sales growth rate of 11.7%, which is significantly larger than the Canadian mattress industry's modest growth rate of 2.7% (Tempur-Sealy Canadian Sales). Palos believes that ZZZ's success is owed to its emphasis on brand recognition, in-store experience, a trained workforce and delivery. Such efforts have translated into the creation of a best-in-class shopping experience for customers. Combined with a focus on upselling additional bedding accessories such as bedframes, pillows and sheets, they have allowed ZZZ to become what Palos considers one of the strongest retailers in Canada. Palos is of the opinion that ZZZ has the potential to open an additional 300 stores, implying over eight years of continued organic growth and increasing market share.

■ What is New on the Macro Level?

By Hubert Marleau

Our Take On The Canadian Dollar

On December 18, 2015, we estimated that the fair exchange value for the Canadian dollar is around 80 U.S. cents if oil trades near the estimated $45 breakeven cost of producing a barrel of oil.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.25	6.84%
Palos Equity Income Fund - RRSP	PAL 101	$5.95	3.87%
Palos Merchant Fund L.P. (Mar 31, 2016)	PAL 500	$5.95	-3.52%
Palos IOU High Yield Fund (Apr 29, 2016)	PAL 701	US $8.18	1.26%
Majestic Global Diversified Fund (May 6, 2016)	MAJ 100	$5.18	1.81%
S&P TSX Composite			7.16%
S&P 500			1.81%
S&P TSX Venture			28.31%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			6.25%

Chart 2: Market Data*

	Value
US Government 10-Year	1.75%
Canadian Government 10-Year	1.32%
Crude Oil Spot	US $46.43
Gold Spot	US $1,264.70
US Gov't10-Year/Moody BAA Corp. Spread	289 bps
USD/CAD Exchange Rate Spot	US $0.7788

* Period ending May 12, 2016

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Indeed, Thursday morning, the Loonie was trading for 78.05 U.S. cents while a barrel of oil was settling for $47. Palos believes that such a correlation is likely to strengthen, as other factors affecting foreign exchange sentiment, including monetary policy differentiation—specifically, in regards to the U.S.—and government debt levels, lose relevance.

Since the start of 2016, we have observed the convergence of Canadian and U.S. monetary stance and monetary policy expectation. Interest spreads—both short and long—between the U.S. and Canada have significantly decreased; the two-year interest rate differential has narrowed from 90 bps to 15 bps, while the ten-year bond yield differential has narrowed from 80 bps to 40 bps. Monetary policy differentiation is thus unlikely to play a big role in the near future, as it did in 2015 when the Bank of Canada's application of an easier monetary stance than that of the Federal Reserve Bank and the dovish rhetoric of Governor Poloz drove a rapid decline in the Loonie's value.

Furthermore, there exists evidence against fears of large increases in Canada's budget deficit and an unfavorable current account that would normally imply negative pressure on the value of the Loonie and hamper its ties to the price of oil. In fact, the ratio of government debt to GDP is relatively low in Canada in comparison to other developed countries, so it is arguable that the government will be able to finance itself without too much difficulty.

Accordingly, the relationship between the value of the Canadian dollar and the price of oil should only be reinforced, and the Canadian dollar should thus continue to trade in a narrow range around 79 U.S. cents for the foreseeable term, so long as the oil price does not climb to $70/barrel (as many believe will be the case soon). Therefore, Palos' exposure to US dollar assets is limited, to oil assets normal, and its cash position is higher than usual.

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

Chart 3: Palos International Fund (Total Returns)*

	Last	YTD Returns
Palos International Equity Income Fund PLC - CAD	CA $4.47	-0.58%
Palos International Equity Income Fund PLC - EUR	EUR 5.37	4.09%
S&P TSX Composite - CAD		5.37%
S&P TSX Composite - USD		12.08%

* Period ending May 9, 2016