Issue 29

PALOS
INVESTMENT FUNDS

July 20, 2017

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

A Small Cap With a 7% Dividend and Much More

Pivot Technology Solutions Inc. (TSX: PTG) is a small cap dividend payer that is more than just a cash cow. The company has been paying dividends, reducing debt and buying back stock. Not many investors have heard of this company as its market cap is under $100 million. However, this company is expected to generate $1.5 billion USD in revenue and $32M in EBITDA for 2017. The EBITDA margins are currently at 2%, but are expected to expand in the coming years as the company focuses on its managed services. We are expecting managed services to grow from 10% of revenue to 30% in the coming years. Presently, most of the company's revenue comes from the value-added reseller (VAR) segment. Its VAR business is underpinned by very strong customers, of which approximately 70% are fortune 100 enterprises. As the company diversifies away from its VAR business and into managed services, we can expect more recurring revenue, long-term agreements, better visibility and increased margins.

It must be noted that the VAR business is important and well-established, especially since Pivot has a strong relationship with suppliers like Cisco, Juniper, Samsung, Oracle etc.

In 2015, Pivot brought in Kevin Shank as CEO; whom Palos had the privilege to meet last month. Mr. Shank has 20 years of senior leadership experience in the industry. After speaking with Mr. Shank, we are confident that the company has the right management team to attain its goal. The funds have invested in Pivot for the following reasons:

- The company has a plan
- Management is focused
- It possesses a strong cash flow profile (Dividend yield, NCIB, and Lower Debt)

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.46	1.06%
Palos Equity Income Fund - RRSP	PAL 101	$6.25	1.19%
Palos Merchant Fund L.P. (Mar 31, 2017)	PAL 500	$4.13	1.36%
Palos IOU High Yield Fund (May 31, 2017)	PAL 701	US $7.00	-3.83%
Palos WP Growth Fund - RRSP	PAL200	$9.84	-1.59%
S&P TSX Composite			1.35%
S&P 500			11.71%
S&P TSX Venture			50.31%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			4.13%

Chart 2: Market Data*

	Value
US Government 10-Year	2.26%
Canadian Government 10-Year	1.88%
Crude Oil Spot	US $46.79
Gold Spot	US $1,243.90
US Gov't10-Year/Moody BAA Corp. Spread	208 bps
USD/CAD Exchange Rate Spot	US $0.7944

* Period ending Jul 20, 2017

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- Favorable secular trends in IT. We continue to see higher spending and more complex projects.
- Focus on margin expansion and recurring revenue.

Furthermore, the valuation of the company is also extremely attractive compared to its US peers. We believe that Pivot should trade at a discount because of its size. However, we do believe that the delta between US peers and Pivot is way too large. The average US peers trade at 14.2x P/E and 7.5x EV/EBITDA, whereas Pivot trades at 3.1x and 5.2x respectively. We believe Pivot is at risk of being acquired if multiples don't start to expand.

■ What is New on the Macro Level?

By Hubert Marleau

On the US Economic Outlook

The U.S. is in the third longest economic expansion since 1850; sparking fear in the marketplace that it's time for it to die of old age. While it is the longest and the weakest upswing in the entire post-war period, end-of-cycle pressures are absent. For example, wage pressures are incredibly muted, inventory levels are low relative to sales, inflationary pressures are missing and productivity gains are dull. Economists are generally confused and do not have a good explanation for all of this. In our judgement, there are a few reasons for the odd shape of the economic recovery. Firstly, the longer it takes to absorb slack created by the "Great Recession," the longer it takes to reach full employment and full utilization of industrial capacity. The indicators that usually signal the end of cycles are normal. None of the required conditions are met in a convincing manner. We're not at or over capacity, commodity prices aren't overheating and household and business debt loads aren't bad. Viewed in another way, the recession risk is virtually nil. The chances that a recession will occur in the next twelve months is 11% according to Moody's Analytics. Secondly, we have strong conviction that the unemployment rate is still above its natural rate. A more plausible full employment situation is a 4.0% unemployment rate. Technology is reshaping the relationship between employment, wages and investments. One only must think about the "gig economy" which allows companies to hire workers by task or hour, rather than by year. Accordingly, the labor supply is stretchy, allowing companies to expand their business without taking risky bets like making long-term investments or hiring workers for long periods. Thirdly, technology is giving business better insight into the link between inventory levels and the supply chains. In this connection, the resources of the economy are better synchronized and, in turn, making it possible for businesses to be risk averse.

Furthermore, low sluggish growth means that the current cycle has a long way to go before inflationary pressures rear their ugly head. It has also reduced economic volatility. Over the past three years, the standard deviation of the annualized change in U.S. GDP, how far it has deviated from its underlying trend each quarter, is historically low at only 1.5%.

Overall, interest rates can only rise gradually and not by very much. At worst, they will be normalized and we are almost there. Big Economic Indicators like retail sales, industrial production, employment and ISM surveys combined with High Frequency Models, suggest that economic growth over the coming months will be sustained around 2.0% with an inflation rate of no more than 2.0%. The 3.5% economic growth of the "Make America Great Again" ideology is overreaching. It is hard to believe in the arithmetic. It might be achievable, but the political gridlock in Congress and the dysfunctionality of Washington make it unrealistic.

The post-election surge in consumer confidence has fully reversed. Business owners are questioning if, indeed, the Trump administration can accelerate the economy amid all the existing roadblocks. What we have, yet again, are economic prints consistent with 2% growth in 2017 and 2018. As a matter of fact, GDP estimates for the second quarter have been revised downward. Optimistic estimates at the start of the June quarter aren't as rosy as they were a few months ago. More evidence of this includes:

- The New York Fed said its "nowcast" has been reduced to 1.9% from 2.6% in April.
- The Atlanta Fed reported that its "GDPNow" fell to 2.5% from 4.3% in May.
- IHS Markit has cut its GDP estimate to 2.4% from 2.7% and so have Barclay's Bank and Macroeconomic Advisors.

The bottom line is that the new economic prints are narrowing the wide gap between soft and hard economic numbers, suggesting that the U.S. economy is still in a two-plus-two pattern. That is 2% for growth and 2% for inflation. We carefully watch the performance of copper prices and the

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U.S. Dollar Index. These numbers can give a quick and dirty view as to whether reflation is on. The Dollar Index is currently just above a ten-month low and the copper futures have broken out from a bearish consolidation pattern, firmly suggesting that a moderate reflation scenario continues to be the most probable outcome.

On Jamie Dimon, Chief Executive Officer of JPMorgan Chase:

Jamie Dimon is a feisty animated big boss man. While reporting quarterly results last Friday, he let loose with a harangue against the politicians in the U.S. and the Washington gridlock. He said:

- “Since the Great Recession, which is now eight years old, we’ve been growing at 1.5% to 2.0% despite political stupidity gridlock”
- “We are unable to build bridges, we are unable to build airports, our inner-city schools are not graduating”
- “I just went to France, I was in Argentina, I was in Israel, I was in Ireland. We met with the prime minister of India and China. It’s amazing to me that every single one of those countries understands that practical policies to promote business and growth is good for the average citizen of those countries, for jobs and wages, and somehow, this great American free enterprise system no longer get sit”
- “Corporate taxation is critical to that, by the way. We’ve been driving earnings overseas, which is why there’s $2 trillion overseas benefiting all these other countries and stuff like that. So, if we don't get our act together, we can’t grow.”
- I don’t buy the argument that we’re relegated to this forever. We’re not. If this administration can make breakthroughs in taxes and infrastructure, regulatory reform--we have become one of the most bureaucratic, confusing, litigious societies on the planet”.
- “It’s almost an embarrassment being an American citizen travelling around the world and listening to the stupid shit we have to deal with in this country. And at one point, we have to get our act together or we won’t do what we’re supposed to do for the average American”.
- “And unfortunately, people write about this saying it’s like this for corporations. Competitive taxes are important for business and business growth, which is important for jobs and wages growth. And honestly, we should be ringing that alarm bell, every single one of you (analyst), every time you talk to a client”.
- “There would be much stronger growth if there were more intelligent decisions”.
- “Who cares about fixed-income trading in the two weeks in June”.

Interestingly, Blackstone Group CEO, Steve Schwarzman, empathizes with Jamie Dimon, saying that he also isn’t happy with the state of U.S. politics.

On a New Book: Destined for War by Graham Allison

Allison, the director of Harvard Kennedy School’s Belfer Center for Science and International Affairs, resurrects the famous Samuel Huntington's thesis of a coming clash of civilizations to explain that China thinks in longer time frames and with greater sense of hierarchy than the U.S. He argues that it may become impossible for America and China to escape the renowned “Thucydides’s Trap”. The trap occurs when both sides labor strenuously to avoid war but are seemingly and primarily driven to it by forces like fear, interests and valor. In this connection, he alludes to the Peloponnesian war of 431-404 BC. Thucydides wrote that it was the rise and hubris of Athens and that the fear and paranoia of Sparta are what made war inevitable. Reviewing the past 500 hundred years, the Harvard Thucydides’s Trap Project has identified sixteen cases in which an ascending power challenged an established power. Twelve of these rivalries resulted in war. The bottom line is: “Will it be more difficult for the Chinese to rationalize a cosmology in which there are two ‘suns’, or for the U.S. to accept that it must live with another, and possibly superior superpower?” The book is a page-turner for it projects a provocative thesis on a very pressing foreign policy issue. Some say that it cannot happen because a nuclear war would be devastating for both sides. Indeed, but today there are various forms of war. There are drone wars, cyber wars, terror wars, trade wars, economic wars, diplomatic wars, financial wars etc.

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Other Noteworthy News

- Last week, China opened a path for the transformation of its financial markets. They may be able match the U.S. in size and lure as more than $3 trillion in capital may come from abroad by 2025, according to a study by Citigroup Inc.
- The Atlantic came out with an article on why the "Impossibility of a Nuclear War" is a myth. Two political scientists, Brendan R. Green and Austin Long question the validity of the mutually assured destruction thesis.

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