PALOS
INVESTMENT FUNDS

January 11, 2012

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

When the Market does not see Further than its Nose

MEG Energy Corporation (TSX: MEG) is a company that is involved in oil sands development and owns oil sands leases. MEG had a terrible 2012; it was down 26% for the year. Its lackluster 2012 performance can be attributed to two factors:

1) The new oil-sands takeover rules that will limit foreign takeovers of state-owned companies.
2) The wide oil differential; MEG currently is realizing approximately $30/Bbl due to high diluents cost and the wider Western Canadian Select Crude differential.

However, MEG has been alleviating some of these concerns by being proactive. On December 10, 2012, MEG announced an $800 million equity financing, half of which came from the Caisse de depot et placement du Quebec. This clearly shows that MEG does not need foreign sovereign funds to continue its growth; it can partner with domestic sovereign funds. This should remove financing risk for the coming years.

Secondly, MEG has been very proactive on the oil differential issue. In late December, MEG and Canexus (TSX:CUS) announced a deal that secured incremental rail and barge capacity for MEG that will allow them to ramp up deliveries to the Gulf of Mexico and get Maya pricing for its crude. Palos is a believer that MEG will be able to rail approximately 80% of its production by the second half of 2013. While for the first

Chart 1: Palos Domestic Funds*

	FundServ	NAVPS	5D Returns	YTD Returns
Palos Income Fund L.P.	PAL 100	CA $8.90	0.51%	1.56%
Palos Equity Income Fund - RRSP	PAL 101	CA $6.89	0.21%	1.02%
Palos Merchant Bank L.P. (Dec 31, 2012)	PAL 500	CA $8.18	---	---
Palos Majestic Commodity Fund L.P. (Jan 10, 2013)	PAL 600	CA $10.62	-0.11%	0.02%

Chart 2: Market Data*

	Value	5D Returns	YTD Returns
S&P 500 Total Return Index	2,586.69	0.43%	3.28%
S&P TSX Total Return Index	36,201.07	0.50%	1.41%
S&P TSX Venture Index	1,240.25	0.98%	1.56%
MSCI All Countries World TR Index (CAD)	3,440.31	0.52%	3.33%
US Government 10-Year	1.87%	-0.03%	0.11%
Canadian Government 10-Year	1.94%	0.00%	0.14%
Crude Oil Spot	US $93.56	$0.47	$1.74
Gold Spot	US $1,660.60	$11.70	-$15.20
US Gov't10-Year/Moody BAA Corp. Spread	188 bps	-3 bps	-3 bps
USD/CAD Exchange Rate Spot	US $1.0155	$0.0026	$0.0103

* Period ending Jan 11, 2013

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half MEG will need to endure the weaker prices, looking forward MEG looks inexpensive, and a great investment opportunity.

Palos has accumulated the stock sub $33.00. Because MEG does not pay a dividend, Palos has been selling out-of-money calls to generate income for investors.

■ Risks, Hedges and Opportunities

By Adam Smalley

Making Loans

The Palos Income Fund made a strategic reallocation this past week. The Fund took profits on National Bank (TSX: NA) and Bank of Montreal (TSX: BMO) and redeployed the proceeds into three US banks: JP Morgan (NYSE: JPM), Wells Fargo (NYSE: WFC) and SunTrust (NYSE: STI). BMO and NA were trades we put on a few months ago that hit our price target. We remain constructive on the Canadian banking sector but prefer to express that view through Royal Bank (TSX: RY), Toronto Dominion (TSX: TD), and Bank of Nova Scotia (TSX: BNS), all of which remain core positions.

Our newly established positions in JPM, WFC and STI are driven by our positive outlook on traditional deposit-taking, loan-making banks in the United States (obviously JPM has many lines of business but it is the largest deposit-taking bank in the US). Consumer and industrial (C&I) loan growth should remain robust and drive earnings in 2013. Clearly the biggest risk to our thesis is a reduction in confidence among potential borrowers. With several “mini-cliffs” on the horizon, this risk is real and will be monitored closely. Otherwise, we think our thesis will pay off as the US economy continues to improve, albeit gradually.

■ What is New on the Macro Level?

By Hubert Marleau

The Point of Inflection for US Monetary Policy

Acknowledgment that the cost and supply of money can have a material effect on the valuation across asset classes, it follows that is it crucial for investors to sort-out what the Fed is up to. Minutes from the FOMC’s December meeting reveal that the FED is expected to keep rates low until the unemployment rate falls below 6.5%, as long as inflation does not go above 2.5%, and will continue to accumulate long term assets at the current pace of $85bn a month until a substantial improvement in the labour market is recorded. The Federal Bank of St-Louis has figured out that a 7.1% unemployment rate is the right number for a change in the the FED’s monetary stance. Current indications show that the rate, currently at 7.8%, should tick down through 2013. The record shows that several members of the FOMC, perhaps as many as five, want to slow or stop purchases of assets well before the end of 2013. As a matter of fact, one member opposes purchases altogether. For the first time since 2008, the FOMC is evenly split. It has been noted that date-based guidance can be taken the wrong way for it may suggest that the FED has information that it does not want to share with the general public. It may give reasons to firms and households to act in a contrary fashion to what reality is. That things have gotten better is not shared by all. Taking a numerical target for unemployment alongside its inflation target suggests that the FED is confident that the economy will soon be restored to full health. There are a number of good reasons to think that the point of inflection is approaching even though it’s not yet upon us.

1) The US private sector boosted hiring in December, showing economic resilience even after a large upward revision to the November numbers.

2) Concerns among market participants are growing that the FED is doing too much and, in turn, raising the potential inflation risks.

3) A significant portion of the shortfall in nominal growth has been filled.

4) An early warning sign of inflation is bank lending. Until recently, much of the money printed by the FED stayed in the Banking system. In the past few months, a noticeable increase in bank lending has occurred. History shows that rising banking activity has reliably foreshadows higher inflation rates.

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■ An article recommended by Hubert Marleau

Please click the link below to access the following article recommended by Hubert Marleau.

"10 Terrible Pieces of Retirement Advice"
Source: Forbes
http://www.forbes.com/sites/abrambrown/2013/01/10/10-terrible-pieces-of-retirement-advice/

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**

	Last	5D Returns	YTD Returns
Palos International Equity Income Fund PLC - CAD	CA $5.19	0.49%	0.49%
Palos International Equity Income Fund PLC - EUR	EUR 7.06	2.28%	2.28%
Palos International Equity Income Fund PLC - USD	US $6.71	1.36%	1.36%
S&P TSX Composite Total Return Index - CAD	35,919.26	0.63%	0.62%
S&P TSX Composite Total Return Index - USD	36,392.36	1.43%	1.43%

** Period ending Jan 8, 2013