Issue 4

PALOS INVESTMENT FUNDS

January 25, 2012

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

Why We Love Uncle Sam

While we recognize that recent stock market performance has a lot to do with the application of easy money in terms of cost and availability, it remains that the US economy is doing fairly well when compared to other developed economies. Corporate profits are beating expectations, confidence about the future has improved and the housing sector is on a significant uptick.

Furthermore, Palos has observed a positive trend in U.S. companies repatriating their manufacturing. According to a survey by Boston Consulting Group, 44 percent of U.S.-based manufacturing companies are planning or considering bringing back production to the U.S. Our thinking is that the U.S. is gaining comparative advantage for three main reasons:

1) Low interest rates and the Federal Reserve backing the system, both of which lead to business confidence.

2) North American energy input costs are lower than anywhere else in the world. If you compare what North America pays for its natural gas versus Asia and Europe you will see differences between $3 and $6. Also, WTI and Canadian crude trade at big discounts to world prices.

3) Five years of corporate and personal deleveraging which has led to a very strong financial foundation.

In this connection, the Palos Income Fund has reduced exposure to many interest sensitive

Chart 1: Palos Domestic Funds*

	FundServ	NAVPS	5D Returns	YTD Returns
Palos Income Fund L.P.	PAL 100	CA $9.09	1.21%	3.71%
Palos Equity Income Fund - RRSP	PAL 101	CA $7.02	1.14%	2.93%
Palos Merchant Bank L.P. (Dec 31, 2012)	PAL 500	CA $8.18	---	---
Palos Majestic Commodity Fund L.P. (Jan 24, 2013)	PAL 600	CA $10.75	0.54%	1.23%

Chart 2: Market Data*

	Value	5D Returns	YTD Returns
S&P TSX Total Return Index	36,851.84	0.78%	3.24%
S&P 500 Total Return Index	2,641.64	1.15%	5.48%
S&P TSX Venture Index	1,227.24	-0.65%	0.51%
MSCI All Countries World TR Index (CAD)	3,516.04	1.24%	5.60%
US Government 10-Year	1.95%	0.11%	0.19%
Canadian Government 10-Year	1.95%	0.03%	0.15%
Crude Oil Spot	US $95.88	$0.32	$4.06
Gold Spot	US $1,656.60	-$30.40	-$19.20
US Gov't10-Year/Moody BAA Corp. Spread	191 bps	0 bps	0 bps
USD/CAD Exchange Rate Spot	US $0.9943	-$0.0141	-$0.0109

* Period ending Jan 25, 2013

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securities such as preferred shares but has increased exposure in the U.S. Moreover, given that it appears that the Fed will likely make changes to monetary policy before Canada, more exposure to U.S.-denominated securities may prove to be a good move in that US dollar could make gains against the CDN dollar.

■ Risks, Hedges and Opportunities

By Adam Smalley

Shopping List

This week Metro (TSX: MRU) sold half of its stake in Alimentation Couche-Tard (TSX: ATD/B) in a block trade, raising $500 million in proceeds. This decision by Metro affects the Palos funds in a couple of ways. Since early 2012, the funds have had a core position in Couche-Tard. Metro's announcement, of course, caused Couche-Tard to trade down a bit (Metro sold 10 million shares, about 20 times average daily volume). We participated in the block trade and added to our position at $47.90, an attractive price in our opinion. ATD/B closed the week above $48.

Metro's decision to sell its ATD/B stake positively affected Safeway Inc. (NYSE: SWY), a trading position owned by the funds. For a couple months now, Safeway, the North American supermarket chain, has been quietly rumored to be a seller of its Canadian assets. Metro and Loblaw will obviously take a look at the Safeway assets and Metro's decision to liquidate its ATD/B stake caused some to conclude that Metro was preparing a bid for Safeway Canada. Regardless, the sequence of events caused many investors to revise their thinking on Safeway, which traded up about 3.5% on the week, as the value of Safeway Canada - estimated between $5 and $6 billion - becomes apparent.

■ What is New on the Macro Level?

By Hubert Marleau

1) The Point of Inflection in the US

Price stability and economic growth are two necessary conditions for performing and superior stock market returns. Given that monetary policy can amplify business cycles and, in turn, affect real economic activity and/or price inflation, it's imperative for serious investors to keep tabs on the Fed and carefully monitor the indices upon which the Federal Reserve bases its monetary stance. In a previous letter, I argued that the changing composition of the misery index, the addition of the inflation and unemployment rates, holds the key as to if and when the point of inflection will be reached. The inflation content of the index decreased to 17.8% in January from 18.8% in December last. As matter of fact, the top-line CPI for urban consumers was unchanged in December after retreating 0.3% in November resulting in a year-over-year increase of 1.7%. It would appear from these numbers that the Fed is not about to change its stance anytime soon. However, appearances can be deceptive for inflation expectations have risen of late. Future gold contracts have edged up lately and the US treasury market for TIPS is expecting an uptick in the inflation rate to 2.5%. The Conference Board's leading, coincident and lagging indicators registered healthy upticks in December suggesting that the time is coming when monetary hand-holding will end and the economic recovery will go forward in a self-sustaining manner. By the look of things, it won't be in 2013. Nevertheless, the bond market tends to move ahead of the Fed. Treasury yields are already up because the market knows that ending the asset-buying program will be the first step to normalize monetary policy. The Fed's path will be to stop the reinvestment, then raise the target rate and lastly sell-off long term debt holdings.

2) The Point of Inflection in Canada.

Comparatively, the Canadian misery index currently stands at 7.9% of which the inflation content is only 10.1% suggesting that a change in monetary policy is less likely in Canada than it is in the US. This is surprising because the unemployment rate is much lower in Canada than it is in the US. Yet, it makes good sense for the Bank of Canada has not made outright purchases of long term assets nor employed any form of quantitative easing. It means that the inflation risk is less.

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■ An Excerpt from "The Dividend Dance," a yet to be published book

By Hubert Marleau

In the next few weeks, I will demonstrate how we pick dividend paying stocks. Decisions are based on five factors. These are Yield, Reliability, Efficiency, Growth, and Value. As a rule, the selected stocks must pass all five tests. We rarely make exceptions and when we do it's usually related to trading tactics or singular opportunities. I trust that you will find it interesting and worthy of consideration. Rules are good and do not always work but they do help to avoid bad mistakes.

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 $5.16	0.95%	2.00%
Palos International Equity Income Fund PLC - EUR	EUR 6.87	-0.37%	0.94%
Palos International Equity Income Fund PLC - USD	US $6.64	-0.49%	1.47%
S&P TSX Composite Total Return Index - CAD	36,873.33	1.53%	3.30%
S&P TSX Composite Total Return Index - USD	37,129.52	0.61%	3.48%

** Period ending Jan 22, 2013