PALOS
INVESTMENT FUNDS

April 19, 2013

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

Our American Cousins

In the past twelve months, Palos reduced exposure to real estate investment trusts (REITs) that own Canadian assets and employing the proceeds to buy REITs with US exposure. Our action was driven by three main components: 1) Valuations of Canadian REITs reached uncomfortable levels; 2) The US economy is performing better than the Canadian one; and 3) US real estate valuations are reasonable and rents are substantially below previous peaks. Our holdings consist of :

Milestone Apartments (TSX: MST.UN): Owns 52 garden-style properties, comprising 16,944 units, diversified across major metropolitan markets in the Southeast and Southwest United States. These markets include Dallas/Fort Worth, Houston, Nashville, Jacksonville, Phoenix, Salt Lake City, Atlanta, Tampa, Austin and San Antonio

HealthLease Properties: (TSX: HLP.UN): Owns a best-in-class portfolio of seniors housing and care properties focused on need-driven care and leased to leading operators under long-term, triple-net leases in the U.S. and Canada. These markets include Illinois, Indiana, Virginia, Pennsylvania, North Carolina, Alberta, and British Colombia.

American Hotel (TSX: HOT.UN): Has been formed to indirectly own and acquire hotel properties in the United States. AHIP's initial portfolio is comprised of 32 hotel properties focused on railroad employee accommodations in 19 states.

Granite (TSX:GRT.UN): Engaged in the ownership and management of predominantly industrial properties in Canada, the United States, Mexico and Europe. Granite owns approximately 29 million square feet in 106 rental income properties.

Tricon (TSX:TCN): Actively purchasing,

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$8.87	3.44%
Palos Equity Income Fund - RRSP	PAL 101	$6.67	0.74%
Palos Merchant Fund L.P. (Mar 28, 2013)	PAL 500	$8.56	7.20%
Palos Majestic Commodity Fund L.P. (Apr 18, 2013)	PAL 600	$11.00	3.62%
S&P TSX Composite			-2.11%
S&P 500			9.72%
S&P TSX Venture			-22.98%

Chart 2: Market Data*

	Value
US Government 10-Year	1.70%
Canadian Government 10-Year	1.71%
Crude Oil Spot	US $88.01
Gold Spot	US $1,395.30
US Gov't10-Year/Moody BAA Corp. Spread	197 bps
USD/CAD Exchange Rate Spot	US $0.9741

* Period ending Apr 19, 2013

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renovating and renting distressed single family rental homes in the Unites States with a network of dedicated operating partners. These markets include Northern California; Southern California; Dallas and Houston, Texas; Phoenix, Arizona; Atlanta, Georgia; and South Florida.

As one can see Palos' real estate exposure is US-based with sector diversification coming from hotels, multi-residential, single family, industrial, and senior housing. Finally, SunTrust Banks reported its financial results on Friday giving us additional comfort that the US real estate sector offers unique investment opportunities.

■ Risks, Hedges and Opportunities

By Adam Smalley

SunTrust

SunTrust (NYSE: STI) reported its 1Q13 results on Friday, beating on EPS but missing slightly on revenues. EPS came in at $0.63 per share versus expectations of $0.61. Although revenue was a little light, effective cost-cutting more than offset the shortfall. On the conference call, STI management's comments were consistent with what we heard from JPMorgan (NYSE: JPM) and Wells Fargo (NYSE: WFC) last week – that all business lines are strong, except for trading. Goldman Sachs' (NYSE: GS) earnings call earlier this week also pointed to lower trading volumes.

STI's results showed that credit quality improved with the percentage of non-performing assets (NPAs) down meaningfully. Overall STI's results reinforced our view that US deposit-taking banks, as opposed to banks driven by capital markets activity, are an attractive investment.

STI was up over 3% on Friday.

■ What is New on the Macro Level?

By Hubert Marleau

The Dark Side of Gold Creates Opportunities

The price of gold stopped going up in September of 2011 after it reached an historical high of $1,920 per troy ounce. The downward slide was characterized by these phases:

1) In 2012, outflows from gold exchange traded products made up more than 80% of total inflows into these products, significantly more than what was experienced in the previous 12 years.

2) US gold related funds suffered a record $9.2 billion of net outflows during the first three months of 2013.

3) Last Friday, trading volume in gold futures hit an all-time high exceeding 500,000 contracts. There are reports of unusually large amounts of naked short selling of paper gold and en masse sell of bullion. This scale of cashing out and shorting is too large to solely attribute to economic fundamentals. It looks like panic, conspiracy or manipulation.

Put simply, anyone who bought paper or physical gold in the last 18 months is losing money. Market participants have chosen to dump gold holdings rather than risk more money as collateral to keep their wagers open and/or ride out the sell-off. In this connection, the price trend of gold has fallen more than 20% and, in turn, the bullion market is officially in a bear state. I do not believe it's because hard core goldbugs are rejecting government money and finance. However, the narrative that gold is a safe haven is false and it is subject to the same market volatility and herd instincts as other commodities. Gold is not safe and certainly not stable.

Firstly, gold is an investment that is not broadly beloved by many. In academic circles, the belief in gold is advance by the Austrian school of economic thinking. It is not held in high esteem by the monetary, Keynesian, behavioural and institutional schools. It seems to the preserve of German pensioners, US libertarians, Chinese gamblers and Indian traders. They are the media pushers and the main cause behind money flow into gold related assets. Accordingly, the bullion market lacks depth, vitality and breadth making it easier for liquidity to dry up. They attribute the recent violent price movements to manipulation by Central banks and/or conspiracy of Governments. They unequivocally believe that precious metals are a better place to invest than government endeavors like bonds and/or capacities of businesses like stocks.

Secondly, the bull run has been running for twelve years until it stopped in September 2011. The situation caused a shift in street sentiment. Big investment banks like Goldman Sachs, Credit Suisse, Sogen, UBS and CIBC, with very large followings, had turned negative and called for a time out. Gold, which trades in US dollars, is getting relatively expensive. In 2000, the S&P 500 was 5.5 times higher than the price of gold

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compared to about 1.0 times today. In the Weekly Letter # 8, issued on February 22, we calculated that that there was about $700 worth of fluff in the price of gold suggesting that $1,200 is the right market price. Interesting coincident for the all-in marginal cost of producing gold is about $1000 to $1100 per ounce. Given that gold is difficult to value for it lacks a yield and therefore purely reliant on sentiment, the aforementioned estimate is as good as any other guesstimates.

Thirdly, Gold is a hedge against actual inflation and inflationary measures of central bank liquidity. Oddly enough, neither has emerged as a threat. It is as if gold has fallen victim to its own success. Until recently, the bullion market has been unaware or in denial that an underlying creeping fear of deflation is coming back to haunt the market place. In a sudden manner, investors are losing patience that higher inflation is inevitable. The treatment of monetary fundamentals is changing. The effectiveness of easy monetary policy may have worked its wonder on preventing a banking fiasco but its effectiveness on the economic recovery is suspicious. The monetary base, which is primarily made up of currency in circulation and bank reserves is 3.6 times larger than it was in March 2008. Yet, the money supply is less than 2 times what it was back then meaning that banks are not using their excess reserves to expand loans to finance business. In the last three months, M-2 is increasing at the annual rate of only 1.6%. Gold may very well be a store of value, but of little use if there isn't any inflation to speak off. Inflation has not arrived despite all the accommodation. Consumer prices have been remarkably quiet, increasing at a less than 2% annual pace with price expectations firmly anchored.

Fourthly, after many years of high-speed growth of 10% plus, productivity in China is slowing down. GDP increased 7.7% in the first quarter of 2013. Of course, this means reduced demand for commodities. More importantly, consumption contributed 4.4 % points to the above growth. Given that a larger amount of new money seems to be finding its way to the middle income cohort and less with exports and infrastructures, China may be serious about its plan to rebalance its economy toward domestic consumption. The Chinese authorities have allowed the renminbi to strengthen vs the US dollar in spite of weaker than normal economic data. The flip side of weaker growth in China is economic rebalancing. This is a necessary factor for remedying global imbalances. It should be welcomed as good news. As a matter of fact, a political transition in China is complete and economic change could be coming sooner than expected.

Lastly, a study by John Cochrane of the University of Chicago has concluded that debt creates inflation no matter what the Fed does. Debt, in the end, is either repaid, defaulted or inflated. And, what drives debt is not taxes or spending, but economic growth. He argues that 2% growth is what it takes to solve the long term debt problem. He points out that the problem is lack of growth and argues that it can be solved. It should be noted that the US population is expected to increase by as much as 1% per year and to bank on 1% productivity growth is acceptable.

PS-1; It should be understood that the long term thesis in gold has not changed, the price is just ahead of itself. Once the dust settles, gold will become an attractive proposition. The yellow metal's long term bull market may have ended, but we would not want to be without some exposure, albeit an underweighted one. The gold record as a long-term hedge against inflation is well established and the recent fall will not trigger its demise. Gold is a currency reserve for many countries and will always play a role in any reform of the international monetary system. Five gold futures contracts are trading above the spot price indicating that gold is still sought after.

PS-2; Mining is a rugged industry, vulnerable to the whims of politicians, accident prone, difficult to manage and very capital intensive. In this regards, it is important to pick gold stocks that have low operating cash cost, low all-in cash costs, long life of quality reserve, strong balance sheets and good leadership and management. We own GoldCorp.

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Chart 3: Palos International Fund (Total Returns) **

	Last	YTD Returns
Palos International Equity Income Fund PLC - CAD	CA $5.01	1.07%
Palos International Equity Income Fund PLC - EUR	EUR 6.55	-1.65%
Palos International Equity Income Fund PLC - USD	US $6.26	-2.37%
S&P TSX Composite - CAD		-1.68%
S&P TSX Composite - USD		-4.31%

** Period ending Apr 16, 2013

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