PALOS
INVESTMENT FUNDS

May 3, 2013

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

Suncor a Dividend Champion

Suncor (TSX:SU) announced a 54% dividend increase and a $2-billion share buyback.

Management has been saying for the past 24 months that they will be focusing on creating shareholder value. It is now very clear that SU's intentions are to grow and return income to shareholders. For the past 24 months SU has been making some difficult decisions, and is now in a position to increase the dividend and implement a share buyback program.

Management is very focused on internal rate of return (IRR). Hence, SU has demonstrated such discipline when they announced that they were not going forward with the Voyager oilsands upgrader project. Palos is pleased to see that SU will not grow just for the sake of growing.

Palos is a supporter of this strategy and believes the company is well positioned to succeed. The new dividend implies an annual cash yield of 2.5%. However, taking into account the buyback program, it implies a 6.7% yield. Palos is expecting the dividend to continue increasing over time as the business grows.

Suncor is a must-own name on all fronts. It is difficult to comprehend SU's current valuation, as management has proven its capabilities. SU is currently trading at 72% of risked NAV, the lowest P/NAV of all the major oil sands producers in Canada. Furthermore, SU has a strong balance sheet and trades at a discount to its peers on a cash flow basis.

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

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.19	7.16%
Palos Equity Income Fund - RRSP	PAL 101	$6.88	3.80%
Palos Merchant Fund L.P. (Mar 28, 2013)	PAL 500	$8.56	7.20%
Palos Majestic Commodity Fund L.P. (May 2, 2013)	PAL 600	$11.01	3.69%
S&P TSX Composite			1.06%
S&P 500			13.95%
S&P TSX Venture			-20.86%

Chart 2: Market Data*

	Value
US Government 10-Year	1.74%
Canadian Government 10-Year	1.77%
Crude Oil Spot	US $95.61
Gold Spot	US $1,464.20
US Gov't10-Year/Moody BAA Corp. Spread	201 bps
USD/CAD Exchange Rate Spot	US $0.9921

* Period ending May 3, 2013

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■ Risks, Hedges and Opportunities

By Adam Smalley

Earnings

About half of the TSX components have reported first quarter earnings as of Thursday, May 2nd. Of those reporting, according to our analysis, 50% beat expectations and 50% missed. The S&P 500 components tell a different story. Over 75% have reported so far and 72% of those have beaten expectations. This is not surprising as energy- and commodity-heavy TSX companies have had challenges so far this year while consumer- and manufacturing-oriented US companies have fared better. It is also no surprise that the S&P 500 is up 14.0% so far this year versus 1.5% for the TSX (total returns).

Moreover, the accuracy of estimates is interesting. Within the TSX, the average "beat" exceeded expectations by 54% while the average "miss" was 61% lower than expectations. For the S&P 500, the average beat was only 25% and the average miss was 20%. There are many reasons, of course, that explain these numbers: a larger percentage of S&P 500 companies have reported providing a larger sample set, there is relatively more analyst coverage of S&P 500 companies, etc.

We will continue to monitor these statistics and report back once first quarter earnings season is over.

■ What is New on the Macro Level?

By Hubert Marleau

How Uncertainty Taxes the Velocity of Money and, in turn, Economic Growth

In the three months ended March 31, 2013, the level of employment and productivity increased 1.5% and 0.3%, respectively, over the comparable period of 2012. The combination produced a year over year real growth of 1.8%. During the period under review, the annual rate of inflation was 1.6% for an overall increase in nominal GDP of 3.4%. For many economic historians, it is surprising that good inflation (just enough price increase to spur spending but not enough to cause any cost push) and real growth have not done better given 1) the amount of fiscal and monetary stimulus that has been provided by the government and the Fed and 2) the relatively good financial shape of the private sector.

The most straightforward answer for the disappointing economic recovery is the lack of velocity, meaning that the speed at which money turns, is too slow. For the record, the turnover of money has continuously and seriously declined since 2007. The velocity of money decreased another 4.3% from the March quarter of 2012 to 2013. There are two main reasons for the reduction in money turnover.

Firstly, uncertainty about currency, regulatory, fiscal, debt and foreign policies amid stalled debates and congressional failures in Washington is causing a lot of "deadweight".

Secondly, uncertainty about the potential deflationary effect of deleveraging amid the financial markets is forcing banks away from making loans and, in turn, channeling their liquidity in the form of excess reserves to the Fed.

These uncertainties come with real and quantifiable costs. In order for the velocity of money to rise, debt increases must create a productive stream of income, like business investments, or durable usefulness like purchasing a car or a house. Put another way, debt must be invested in a manner that will provide a return to repay borrowed funds. Since the bulk of these expenditures are funded with borrowed funds, low interest costs are part of the equation. In other words, an acceleration in interest sensitive expenditures would be needed for real GDP growth to average 3% per year instead of the current 2%. During the first quarter of 2013, interest sensitive spending accounted for 21.5% of N-GDP, about the same as in 2010, 2011 & 2012. US economic history shows that a sustainable ratio of about 25% is what is needed to experience a normal "after recession" economic recovery. Nicholas Bloom and Scott Baker of Stanford University and Steven Davis of the University of Chicago have done, according to the WSJ, an invaluable amount of work on measuring the effect of uncertainty on the economy. Acknowledging their research on uncertainty, it is not surprising that the economic recovery has been so tepid for policy uncertainty has been 50% higher in the past few years than it has been since 1985.

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In this respect, only the Fed has shown certainty. On Wednesday last, the US monetary authorities declared that they would press forward with their bond-buying program and hinted that they may even step on the gas pedal one more time if the job market and inflation numbers don't meet their published expectations.

P.S. The purpose of quantitative easing (QE) is to stimulate interest-sensitive expenditures on residential construction, business capital formation, durable goods, infrastructures, cars and appliances and, in turn, push employment and productivity upward to the level required to speed-up economic growth to 3.0%.

■ A Research Report by Hubert Marleau

Please click on the following link to view a research report by Hubert Marleau, *The Theory of Rational Expectations and Interest Rate Cycles*, published in June of 1979 in Nesbitt Economic Research.

Link to Research Report by Hubert Marleau

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 $5.18	4.42%
Palos International Equity Income Fund PLC - EUR	EUR 6.86	2.95%
Palos International Equity Income Fund PLC - USD	US $6.58	2.61%
S&P TSX Composite - CAD		1.20%
S&P TSX Composite - USD		-0.06%

** Period ending Apr 30, 2013