PALOS
INVESTMENT FUNDS

May 31, 2013

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# Palos Weekly Commentary

## ■ Palos Income Fund

*By Charles Marleau*

### A Flying US Housing Market

US home prices are up 10 percent, sales volumes are rising, and both inventories and foreclosures are down 25 percent. The last time the US housing market experienced double digit gains was in 2006. Furthermore, home prices have been rising in all 20 largest cities.

Palos believes that US housing prices will continue to rise over the next few years. Our thinking:

Housing affordability in relation to incomes or rents still looks low, thanks to ultra-low mortgage rates. The "affordability index" from the National Association of Realtors (NAR) has remained strong (meaning housing prices remain attractive) even as home prices have started to firm up. On average US home prices are just three-quarters of their previous peak.

Home prices have been rising in part because of a tight supply of homes for sale, relative to the number of would-be buyers. What has been keeping the supply tight are homeowners that have mortgages that are equal to or above the property value. As property values rises above their mortgages that will bring new homes for sale in a controlled fashion which will in turn allow the housing market to appreciate in a controlled manner.

Palos is taking advantage of this recovery by investing in US banks, US single family homes, and US multifamily residential companies.

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

| | FundServ | NAVPS | YTD Returns |
|---|---|---|---|
| Palos Income Fund L.P. | PAL 100 | $9.44 | 10.02% |
| Palos Equity Income Fund - RRSP | PAL 101 | $7.00 | 5.62% |
| Palos Merchant Fund L.P. (Mar 28, 2013) | PAL 500 | $8.56 | 7.20% |
| Palos Majestic Commodity Fund L.P. (May 30, 2013) | PAL 600 | $10.90 | 2.62% |
| S&P TSX Composite | | | 3.00% |
| S&P 500 | | | 15.37% |
| S&P TSX Venture | | | -21.02% |

**Chart 2: Market Data***

| | Value |
|---|---|
| US Government 10-Year | 2.13% |
| Canadian Government 10-Year | 2.06% |
| Crude Oil Spot | US $91.66 |
| Gold Spot | US $1,387.50 |
| US Gov't10-Year/Moody BAA Corp. Spread | 195 bps |
| USD/CAD Exchange Rate Spot | US $0.9646 |

* Period ending May 31, 2013

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The Palos Income Fund holds a position in:

**Suntrust Banks (NYSE: STI)** - A super-regional bank that operates in the southern US.

**Wells Fargo (NYSE: WFC)** - A bank that operates all over the US.

**JPMorgan (NYSE: JPM) -** A bank that operates all over the US.

**Milestone Apartments (TSX: MST-U) -** A real estate investment trust that owns multifamily residential properties in the US.

**Tricon Capital Group (TSX: TCN)** - A corporation that owns single family home in the US.

## ■ Risks, Hedges and Opportunities

*By Adam Smalley*

### Short Canadas

The portfolio managers at Palos have been short the Canadian 10-year government bond (10-year Canadas) for much of the past twelve months. We put this trade on for two reasons:

First, it was a spread trade. We shorted the bond on a 2% yield and reinvested the proceeds into higher-yielding corporate bonds and preferred shares that were yielding 5-7%. Our rationale was that we would capture the spread between the two (without deploying much capital since margin requirements on Canadian government bonds are very low) and potentially gain from spread tightening. This trade worked as global spreads between risky assets (corporate bonds and preferred shares) tightened versus risk-free assets (Canadian government bonds).

Second, the trade was an inexpensive option on profiting from rising interest rates. The 10-year Government of Canada bond has a duration of about 9. Duration is important because it determines how much capital appreciation/depreciation occurs as a result of a change in interest rates. A 50 bps increase in interest rates will cause a price drop of 4.5 points in a bond with a duration of 9 (0.50 X 9 = 4.5). That kind of move in bond price wipes out 3 years of interest income. Since the beginning of May 2013, the 10-year Canadian bond yield has increased from 1.67% to 2.09%, a move of 42 bps. The bond's price dropped, as predicted by its duration, by 3.5 points.

## ■ What is New on the Macro Level?

*By Hubert Marleau*

### On Monetary Policy in Canada

What is important to retain from the latest central bank statement is the measured bias toward eventual tightening. This has been the stance of the bank since the recession ended. Palos' Monetary Policy Index is now 50.0 points, much too low to expect an immediate change in the direction of Monetary Policy. While we recognize that overall inflation has been somewhat weaker than expected, the big surprise has been the current account deficit. Statistics Canada reported a smaller than anticipated deficit for the first quarter of 2013 of C$14.1 billion and a downward deficit revision for the last quarter of 2012 to C$14.6 billion from C$17.3 billion. Lower inflation rates and trade deficits account for the amelioration in the Canadian Monetary Policy Index. It may seem odd for the Bank of Canada to talk up an eventual increase in money rates when there is not much on the economic front that suggests any reason for an upward move. It may be the reason why the Loonie is holding up well against the US dollar even though Canadian terms of trade have been under considerable pressure of late.

Palos has meaningful exposure to US dollar denominated assets and Canadian companies that export to the US because terms of trade have proven over the years to be a more reliable factor than the moral suasion of central banks in determining exchange rate movements.

An Article Recommended By Hubert Marleau:

**Bank of Canada**
Bank of Canada maintains overnight rate target at 1 percent.
http://www.bankofcanada.ca/2013/05/press-releases/fad-press-release-2013-05-29/

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

*By Hubert Marleau*

### On Monetary Policy

It is generally believed on Wall and Main Streets that The Fed has been granted sweeping powers to calibrate the cost and supply of money essentially in a highly discretionary fashion totally based on the collective personal judgments and presumed omniscience of the FOMC. The facts do not bear this out. The Fed uses defined rules, specific targets and objective standards. Over the past two weeks, Palos identified several metrics that the Fed uses to make monetary policy decisions. These decisions are far more rules-based than left to the judgment or discretion of a few men. These specific metrics are:

1) The differential between the expected and actual rate of inflation,

2) The percentage of interest-sensitive expenditures to GDP,

3) The inflation composition of the Misery Index,

4) The Money Multiplier and Money Turnover,

5) The Monetary Index,

6) The Taylor Rule and,

7) The N-GDP Growth Target.

History shows that investors who 1) know how Monetary Policy works, 2) understand how defined and observable targets can produce automatic adjustments to monetary policy, 3) scrupulously scrutinize the performance of these aforementioned metrics and 4) act in accordance can have a serious comparative advantage.

THE TAYLOR RULE

According to Wikipedia, the Taylor rule is a monetary-policy rule that stipulates how much the central bank should change the nominal interest rate in response to changes in inflation and unemployment rates. Moody's Analytics use the Taylor Rule to calculate where the federal funds rate should optimally be given what could be considered a desired level of inflation and employment. The Fed has determined that 2% is the appropriate target rate for price stability and estimated that 5.5 % is the natural rate of unemployment or the non-accelerating inflation rate of unemployment. The Taylor Rule Calculator currently shows that the optimal target rate should increase to 0.70% from 0.25%.

*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 $5.29 | 6.52% |
| Palos International Equity Income Fund PLC - EUR | EUR 6.95 | 4.30% |
| Palos International Equity Income Fund PLC - USD | US $6.50 | 1.37% |
| S&P TSX Composite - CAD | | 3.71% |
| S&P TSX Composite - USD | | -0.60% |

** Period ending May 28, 2013