Second Quarter 2013 Investor Letter

Portfolio Comments

Notes on Recent Performance

We acknowledge that we have underperformed in the past several months. We have been tirelessly evaluating our investment strategy, brainstorming other stances, examining past history, and looking for clues in others' analytical work and the technicals of the market to try to better manage your portfolios. This process has led us to look harder at our recent underperformance and see what to change going forward in order to provide superior future performance. After analyzing the causes, we have come to some conclusions. In our investment methodology of analyzing economies, sectors and companies, and assembling portfolios of what we thought were good stocks to reflect our (evolving) point of view, **we misjudged the basic greed and fear instincts that have driven investment beliefs in the marketplace** since late 2011 and especially in the last few months. We erred by believing that fear of financial markets piloted by an incompetent Federal Reserve would prevail over the greed of taking on more risk in markets increasingly driven by reckless Fed policies. We didn't become too bullish after the financial crisis for two primary reasons: 1) disbelief that March 2009 prices would be the bottom, and 2) disbelief that the investing public would follow the Fed post-2008 after it had made so many poor decisions and policy actions in prior years.

First, the March 2009 bottom had two primary elements that bothered us at the time and still do today. One, equities never achieved the values that are typically seen at bear-market bottoms (single-digit P/E ratios and 6-8% yields for the Dow Industrials). The buildup of debt and the misallocation of capital during the prior years, concentrated in the 2003-2007 period, would generally magnify returns on the upside and losses on the downside; in this case, the collapse of markets starting in 2007 and lasting until 2009 would be expected to be on the order of the price decline of the Great Depression, which peak-to-trough cost the US stock market around 90% of its value. While the losses in 2009 approached 58% from the October 2007 peak, the extreme leverage in the financial system pre-saged even larger losses. They ended up not happening due to interventions by the US Government and the Fed (although interventions usually postpone outcomes, not prevent them). Two, the lack of a retesting of the lows reached in 2009 is very unusual; in most markets, once a low is reached, the market rises from that low, but almost universally, markets drop again from the interim high to test the levels defining the bottom. It happened at the beginning of the last great bull market, when the low of early 1980 was retested in mid-1982. It happened coming out of the dot-com bust, when the lows of October 2002 were retested in March 2003. But in this bull market, the lows of November 2008 were definitively broken in February 2009 and by March, prices were 10% lower than the previous lows – however, the market rose and never looked back. Thus, we stayed cautious, believing that the Fed

might have prevented the failure of the US banking system, but not the classical functioning of clearing the excess from the stock market.

The second reason we didn't become more bullish since the financial crisis was our disbelief that the majority of investors and traders would again trust the Fed so soon. The Alan Greenspan-led Fed raised interest rates in 1994 coming out of the 1990-91 recession without enough warning, sending the bond market to its worst year ever (at the time) and leading to the failure of a number of entities – the most notable being Orange County, California which had bought a number of bonds whose performance deteriorated with the rise in interest rates. From that time forward, the Fed has only raised rates reluctantly while it has generally implemented easy monetary policy, often leading to bubbles: 1) after the 1997 Asian crisis/1998 Russian financial crisis, the Fed lowered interest rates, causing the dot-com bubble to form and made it worse when it injected further liquidity into the system to avoid Y2K disruptions, sending the Nasdaq soaring to 5000 – a level never approached since, and 2) in 2003, in reaction to a still-low stock market and a slow economic recovery from the 2001/2002 recession, the Fed dropped interest rates to a historic low of 1% and kept them at that level for nearly a year, causing both the housing bubble and the attendant credit bubble (characterized by packaged mortgage bonds and synthetic bond products, a number of which ultimately proved to be worthless or near worthless). To top it off, the Fed disclaimed any problems before these bubbles burst but afterward (during the early stages of losses) proclaimed that losses would be contained and not affect the economy or the financial markets appreciably. They were repeatedly wrong, and we believed that the financial community would be much more cautious about investing with the Fed as the only real backstop – we have been wrong in that analysis as investors have picked high-flying growth stocks and ignored that extremely easy money policies have **always** led to subsequent high inflation and declining stock valuations in the past.

The problem is that struggling US (and world) economies are generating tepid economic growth (at best) while financial markets move higher, led by US equity markets. Uneven, growth-depressing fiscal policies continue to dog US, European and some Asian economies, yet equity markets have been rising, mostly due to worldwide central banks following ultra-easy monetary policy strategies. At the right valuations, we would participate in more traditional equity investments in size, but the valuation statistics and historical results of similar periods of US equity valuations are daunting. According to John Hussman of the Hussman Funds, in his Weekly Comment, "Investment, Speculation, Valuation, and Tinker Bell," he defines the market as "overvalued, overbought and overbullish" due to:

> "… an observation, [n]ot a prediction, but merely an observation. The last time bearish sentiment was below 20%, at a 4-year market high and a Shiller P/E above 18 (S&P 500 divided by the 10-year average of inflation-adjusted earnings – the present multiple is [now 24.4]) was … in May 2007 …The next instance before that was two weeks in August 1987 [right before Crash of '87]…The next instance before that was for 3 weeks of a 5-week span in December 1972 and January 1973, which was immediately followed by a 50% market plunge."

Hussman updates these observations in his Weekly Comment "Baked In The Cake" where historical patterns that fit this current market, **it is the central expectation that this cycle is half finished and**

that there is typically a 40-55% loss that completes a bull and bear cycle, where we have only seen the first (bullish) half.

Thus, it strikes us as incredible that the investment world believed the Fed could engineer a 'Goldilocks' economy ("not too cold, not too hot") by creating huge amounts of monetary reserves for the no-longer-nearly-insolvent money-center banks. The Fed has caused problems and mismanaged the "solutions" in the recent past, and yet the financial markets still followed the Fed's lead, as one pundit quipped, "like dumb fish". The bond market has also been buoyed since 2011 by bouts of Fed bond-buying, driving short and long-term interest rates to historically (and artificially) low levels in 2012. While this strategy has allowed homeowners to refinance houses (providing more discretionary income for spending) and companies to refinance or borrow more, encouraged by extremely low financing costs (which have contributed to historically-high profit margins), such market-distorting rates also typically lead to suboptimal investment decisions. With such low interest rates, investors seeking yield have been pushed into bond-substitutes like utility stocks, real estate investment trusts, master limited partnerships, and large-cap, dividend-paying stocks, leading to higher than normal valuations in a tepid economic environment. **This is the big disconnect – while corporate profits have prospered from low interest costs and low wage costs (due to surplus labor coming out of the recession), the economy has shown the worst growth coming out of recession since World War II.** Thus, the Fed has driven up stock prices by sending bond yields to all-time historic lows, but these historically low rates have not helped the economy much – leading to the underperformance of commodities, which are usually connected with strong economic growth (the slowdown of the Chinese economy has also greatly impacted commodity perceptions and prices). This moderation of commodity prices, coupled with the lack of wage-level growth due to chronic underemployment, has fed the perception of low inflation. Thus, manipulated interest rates have led to high bond prices and low rates, driving those seeking yield to the equities markets, driving up stock prices, while economic growth has been very slow leading to low inflation perceptions.

Meanwhile, in September/October 2011, gold was setting new all-time highs as the financial markets and the US stock market were stumbling after the dysfunctional US government haggled over the debt ceiling and budget deficits, coming dangerously close to defaulting on US Treasuries and causing US government debt to be downgraded from its Triple-A rating. The US Federal Reserve's two doses of quantitative easing had seemingly staved off a new depression, but the US economy (coupled with slowing European economies) was barely responding. It was a time of maximum angst, and that angst drove investors into safe haven investments, led by the precious metals. Deflation was still a distinct possibility in many investors' minds, which would potentially lead to the deflationary depression that had been avoided in 2008/2009. At that point, Ben Bernanke and the Fed performed (in retrospect) true magic; they upped their rhetoric that they would use their resources in any way possible to support the economy, backed up by their "Operation Twist" program, in which the Fed bought more long-term Treasury bonds and sold T-bills. This rhetoric and the new program appears to have "told" the securities markets that the Fed was going to provide even more support (which eventually expanded into the so-called QE3 and QE4 programs in 2012) to the markets. **The Fed also told markets that essentially the Fed was going to manage the financial markets further to achieve its stated goals to support the Fed's main focuses: the stock market, the bond market and the housing market.** Financial markets took the cue, embracing an uncertain stock market and an

overvalued bond market **(regardless of the risks and valuation)** – relying on the Fed to truly "have their backs" and that the mythical "Bernanke put" was not only real but ongoing.

The belief in the Fed's "management" has continued to pervade the US stock markets. After stocks rallied from late 2011 to summer 2012, the market started to falter as valuations became stretched and the bullish run lost momentum. However, after some hints, the Fed came to the rescue with the $45 billion/month QE3 bond-buying program. After the stock markets corrected in November 2012 (aided by the bearish outcome to the elections), the Fed hinted at and then announced "QE4", which kept up the long-term bond buying of Operation Twist but omitted the short-term T-bill sales, thereby introducing even more liquidity into the markets. Even the "100-ton gorilla" bond market behaved, rallying after "structured management" of Operation Twist was announced and only backing off slowly after the QE3 and QE4 announcements. Finally, by espousing its drive for higher asset prices which would cause the wealth effect to drive renewed growth in the economy, the Fed also got housing to continue to appreciate in price, driven mostly by suppressed long-term interest rates (and the threat of future inflation, although the Fed didn't have to mention that part of it). The slowing of the rest of the world's economies, especially in China, has led to underperformance in emerging stock markets. Commodities have generally been associated with China, so most commodities have performed poorly during this period. Precious metals, technically commodities, are more influenced by monetary factors, but they appear to have been swept up in the China liquidation trade. The increasing certainty of Fed support lessened the need for the security and protection of natural resources investments – especially precious metals. They were sold, and later sold short (according to the weekly CFTC Commitment of Traders report), to the point that they entered a bear market and were pushed into a "weak trend" according to technical analysis.

So where do the greed and fear fit in? We are still surprised at how fear of markets stemming from the 2008/2009 financial crisis still abounds. However, at the same time, people seem willing to take larger and larger risks – the dominant investment theme for at least the past 18 months has been: do more of what has done well **regardless of rising risks! The fear of investing in out-of-favor investments, coupled with the greed of participating in currently-successful investment themes has been driven to risky extremes. Why? Because people continue to project the current into the future and believe central banks will always be able to save them with new programs – a belief system that is increasingly unrealistic and is causing investors to build more and more risk into their portfolios.**

To sum up our more recent underperformance, traders and investors have embraced the Fed's (and other central banks') management of economic conditions. This greatly lessens the need in traditional investors' eyes for the independence and security of owning hard assets that hold value, like natural resources, and most especially, precious metals and associated companies. **We obviously disagree with this notion and have invested on a longer time scale in which we believe our views (and portfolio valuations) will be vindicated starting later this year. One of the most powerful concepts in investing is "reversion to the mean", and we believe markets will start to embrace cheaper, out-of-favor companies like natural resource producers and shun high-valuation, high-multiple growth stocks as economic fundamentals remain moribund. Eventually, all the money being created by the world's central banks will force more investors to protect their capital and**

sell higher-risk positions, like bonds and high-multiple stocks. We may protect our positions with some hedging if we see some more weakness in our positions, but we believe our portfolios are positioned for explosive growth, as we highlight in the Going Forward section of the letter below.

Recently, the Fed's presentation of an economic scenario of improved US economic conditions that could lead to a taper of its current quantitative easing program resulted in a bond market rout during May and has continued into June, showing the tenuous influence the Fed has on long-term bond yields (they don't have as much control of them as they may have thought). **Higher long-term yields threaten both the current housing recovery and the ability for the US Government to control deficits due to higher interest costs. Thus, we believe the Fed won't taper much, the European Central Bank will back its easy money rhetoric with more monetary stimulus, and natural resources will be re-judged to be more integral to institutional portfolios, leading to higher commodity and commodity company stock prices.**

First Quarter Market Conditions

In April, the US stock market came off a strong March trying to make new highs, but encountered resistance in the first few days. However, expectations of higher corporate earnings to be reported drove the S&P 500 to an all-time high of 1587.73 on April 10th. Bonds also rallied strongly, as tepid economic statistics in the US and deteriorating statistics in Europe and Asia led bondholders to believe Fed bond-buying would continue long into the future. As noted in the last Investor Letter, precious metals were blasted in mid-April as a bear raid on prices and booming US stock and bond markets pushed gold and silver prices to multi-year lows. West Texas Intermediate (WTI) oil prices started April near the year's highs around $98/bbl, but along with metals prices, energy prices plummeted mid-month as worldwide inflation fears were seemingly ignored by financial markets. After reaching a low under $86/bbl, West Texas Intermediate (WTI) crude rebounded strongly to close the month above $90/bbl.

US stocks continued their winning streak during May, but most other assets lost ground. The S&P 500 returned 2.34%, but it was well off its highs reached in mid-May. Precious metals revisited their April lows and rebounded, although not to beginning of May levels. But the real carnage was in bonds, where recent highs from late April were retraced with a vengeance. 10-year Treasuries, trading at a yearly low yield of 1.61% on May 1st (and a yearly high in price) rose in yield (fell in price) virtually all month to reach an end-of-May yield of 2.13%, a rise in yield of 31.5%! An early month correction was exacerbated late in the month when Fed Chairman Bernanke said in testimony before Congress that some tapering of the Fed's bond-buying QE4 program could happen this year, although he certainly didn't signal that tapering would happen. The minutes of past Fed Open Market Committee and Fed Advisory Council meetings confirmed some members called for a slowing of Fed bond buying, spooking virtually all stock and bond markets, although precious metals markets staged a classic reversal pattern that same week showing some strength. Internationally, the "fireworks" were brightest in Japan, where Bernanke's comments caused investors to re-examine Japan Central

Bank's quantitative easing policies – the six-month rally in Japanese stocks retraced around 20% of the gains from its run starting last winter. The Japanese yen strengthened as financial players unwound yen carry trades and bought yen to replace their short positions. Oil prices dropped slightly during May, after energy prices rallied throughout most of the month but dropped back near unchanged after the Fed's tapering thoughts were revealed to markets on May 22nd.

June led to more fireworks in world markets: most notably, US long-term interest rates continued their rise, hit further by the Fed's scenario planning around how it would taper its QE4 bond purchases if the economy continued to improve. The bond market took the Fed's planning as a forecast for improved conditions, and sold off strongly through most of June, hitting a high of 2.65% on the 10-year Treasury, more than 1% above the May 1 level making a huge 63% move in one of the largest markets in the world. "Taper talk" also caused the S&P 500 to have its first losing month of the year, down 1.34% (after dividends), led by materials, tech and energy stocks. Crude oil rose from a June 1st low near $91/bbl to an end-of-month price near $96.50/bbl, reflecting Middle East political concerns around Syria and Egypt and an improving supply/demand balance worldwide. [WTI crude oil prices have subsequently jumped up to over $105/bbl, showing more of oil's continuing strength in July.] Natural gas closed the quarter down to $3.56/MMBtu as cold weather in April (which had driven prices to $4.40 on May 1) gave way to moderate weather in May and June, driving down demand and prices. But the real action was in metals: precious metals, industrial metals and coal all took it on the chin, best illustrated by gold which lost 12% due to weak technicals and Bernanke's threat of tapering monetary easing (discussed in more depth below). Japan rebounded from May concerns as improvement in the Japanese economy, coupled with US dollar strength, drove Japanese stock prices higher and the yen lower by month's end. Emerging market stock markets were losers during June, continuing their May weakness, as Chinese economic results continued to be weak and yen weakness concerned investors about the export competitiveness of other Asian countries – especially Korea and the Southeast Asian countries. Brazil also continued its slide, down another 13% in June due to a sputtering economy and high currency. Brazil characterized the weakness of the BRIC countries during the quarter. All-in-all, June produced a lot more uncertainty toward domestic and global economic outlooks, muddying the waters of financial predictions for the rest of the year.

Precious Metals

Before we relate the specifics of the precious metals action during the quarter, we are reminded of the book/movie *Moneyball: The Art of Winning an Unfair Game.* In the book, Billy Beane, general manager of the Oakland A's baseball team, is constantly confronted by the difference in the payroll that he can pay his players and the payrolls of "large market teams" like the New York Yankees, Boston Red Sox and others that have much larger revenue streams and thus the ability to pay players much more (there is no salary cap in baseball, so teams can spend whatever they decide to spend, subject to their revenue from TV, games, concessions and merchandise). In 2002 Beane discovers and embraces the approach of more in-depth research, eschewing traditional scouting parameters and using the ideas/brain power/computing power of a young quantitative analyst to pick players and put together a roster. Beane and the Oakland A's front office implement the strategy, and for the first half

of the season, the results are dismal as the team is without its former stars (lost to free agency) and the current players feel "thrown together". However, the approach is sound, and after falling into last place, the A's go on an epic winning streak, which eventually stretches to 20 consecutive wins, a streak not seen in the big leagues in 67 years. The A's go on to win their division with an American League-best 103 wins with a $41 million payroll, less than 1/3 of the Yankees "monster" payroll. Although they don't reach the World Series that year, the approach produces division winning teams three more times in the next ten years (and they currently have the 2nd best record in the major leagues this year), even though other teams have also used the same methods to make effective players more expensive.

We highlight *Moneyball* because we believe that our investing methodology is equally as effective as Beane's approach to finding undervalued assets that are out of favor and in the future become very effective investments that will take us on our own "winning streaks". The resource stocks, especially precious metals mining companies, are currently out of favor, but have for the most part streamlined their operations, revamped management, and secured valuable reserves with attractive economics – even at the currently depressed prices of metals we saw in the second quarter.

As referenced in last quarter's Investor Letter, the precious metals experienced a large mid-April sell-off, sending all of the metals to multi-year lows as investors capitulated and many sold their positions in what seemed like a cathartic blood-letting. What market technical traders call a "reflex rally" followed, with metals recovering about half of their recent drop, but then metals prices revisited the lows in mid-May. As gold and silver prices were recovering, the Fed, during its June meeting press conference, signaled a ***possible*** scenario for slowing its QE4 bond purchases. This caused the financial markets to reprice Fed tightening, which hit precious metals during their fledgling price recovery, knocking both metals (and platinum and copper) down to multi-year lows.

For the quarter, Gold lost 23%, closing at $1,223.80/oz and silver lost 31%, closing at $19.56/oz. Gold and silver mining equities continued their slide after the Fed announcement until late June, when gold and silver set new low prices. Mining equities rebounded strongly with strong gains during the last two trading days of June, on large volume. While we have seen similar powerful signals of bottoming in the past, a number of formerly skeptical market analysts proclaimed that they thought this move in metals had reached the bottoming zone. We will present more thoughts on our optimism about precious metals in the "Going Forward – Precious Metals" section below.

After the large drop, bottoming, and rebound of prices, the other notable feature in the precious metals markets was the almost unbelievable amount of purchases of physical gold and silver bullion and jewelry that occurred after the price drop. April was **by far** the largest month of physical bullion purchases around the world, with May also being a very heavy month for physical sales. Most bullion shops and many jewelry shops were swamped with customers for weeks during April and May, with many stores selling out of all their merchandise containing physical gold. While futures and institutional physical bullion trading volumes are much larger than physical sales to individuals, such a large outpouring of purchases shows the appeal of precious metals to individuals looking for security, inflation-protection and a long-term store of value in many countries around the world.

KANOS
CAPITAL MANAGEMENT, LLC

<u>We think there is one last point to highlight: why we have stayed with positions that in the short-term have performed so poorly. First and foremost, we believe the fundamental reasons supporting such investments are as strong as they ever have been, advocating for maintaining [or even increasing] our exposure. But the second point is more experiential: we must have a position to be able to take advantage of the future price appreciation, and by selling our position, it is difficult on an emotional and an analytical basis to re-enter positions you have recently abandoned.</u> We think that this concept is expressed very well in one of the classic books of the investing world, *<u>Reminiscences of a Stock Operator</u>* by Edwin Lefevre, a fictionalized biography of 1900s master speculator Jesse Livermore. In the book (originally published in 1923 but reprinted numerous times since 1980), the main character, Larry Livingston, makes a startling discovery about his trading methodology (pp. 68-69):

> "After spending many years in Wall Street and after making and losing millions of dollars I want to tell you this: It never was my [trading] that made the big money for me. It was always my sitting. Got that! My sitting tight! It is no trick at all to be right on the market…Men who can be right and sit tight are uncommon. I found it one of the hardest things to learn…
>
> "The reason is that a man may see straight and clearly and yet become impatient or doubtful when the market takes its time about doing as he figured it must do. That is why so many men in Wall Street, who are not at all in the sucker class, not even in the third grade, nevertheless lose money. The market does not beat them. They best themselves, because though they have brains they cannot sit tight. Old [Mr. Partridge] was dead right in [staying in his position]. He had not only the courage of his convictions but the intelligent patience to sit tight…
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> "Disregarding the big swing and trying to jump in and out was fatal to me [in the past]. Nobody can catch all the fluctuations. In a bull market your game is to buy and hold until you believe that bull market is near its end."

Energy

As mentioned above, a colder-than-normal winter in the northern hemisphere and the continued (albeit slower) economic growth in Asia pushed up WTI crude prices going into the quarter. However, deteriorating economic statistics in the US and China caused prices to drop in mid-April to $86/bbl. This level proved to be the quarter's bottom, after which a rising stock market and some optimism regarding the possible bottoming of the world economy led prices to recover much of the rest of the quarter, staying above $90/bbl and ending the quarter at $96.50/bbl. Interestingly, crude mimicked the weakness in precious metals until June, when crude stayed very strong (even after a large one-day, Fed induced drop) while metals weakened until late June. These prices occurred with US inventories being near multi-year highs, meaning that production in the rest of the world must be weaker than analysts have thought, and demand worldwide must be stronger than thought. Ongoing political tensions in Syria and Egypt have contributed to the strength of crude prices. As headlines receded, prices only dropped modestly, showing WTI prices have had little real connection to Middle East tensions – so, supply/demand concerns would appear to be the major driver of price strength lately. As mentioned above, natural gas benefitted from a long winter that reached into April, driving prices above the $4.40/MMBtu level. However, milder weather in May caused a big sell-off and prices failed to maintain a late May retest of the highs. June brought renewed demand but plenty of supply, and prices fell during much of the month ending just above $3.50/MMBtu. Interestingly, both WTI and natgas prices have rallied during the first part of July, with crude prices rising above $105/bbl and natgas into the $3.70s/MMBtu as supply/demand factors continue to tighten.

Equities

US equities showed modest gains in the second quarter, with the S&P 500 gaining 2.4% and the much broader Russell 2000 gaining 2.7%. The Dow Jones Industrial Average gained 2.3%. As chronicled above, it was a rollercoaster of a quarter, with a small correction in early April, followed by a strong advance from mid-April to late May, when the market's interpretation of Fed tapering of quantitative easing led to a month-long sell-off, followed by a rise during the end of June. Many investors saw the market's failure to shrug off the fear of QE attenuation as a serious concern about the sustainability of the advance, while others saw the correction as healthy and which would lead to new highs later in the summer. Major sectors that outperformed in the quarter included Financial, Consumer Discretionary and Health Care, while major laggards were Utilities (rate-sensitive like bonds), Materials and Energy (in spite of strong oil prices during much of the quarter). July has proven to be bullish for US stocks, as Bernanke's and other Fed governors' dovish rhetoric has helped propel markets higher; the real concern is for 2Q profits – they are generally believed to be flat to weaker, which might further weaken US economic results (1Q US GDP was revised in final revisions down to 1.8% [a large drop from 2.4%] and 2Q GDP estimates have fallen to around 1%).

Bonds

Bond prices were strong during April as investors became concerned about economic weakness; 10-year Treasury yields dropped to 2013 lows of 1.615% on May 1. However, for much of the rest of the quarter, bond prices weakened (and yields rose) as the US economy appeared to show some improvement and bond investors worried about the Fed might start to lessen the amount of monetary stimulus being provided. When Fed Chairman Bernanke gave his periodic economic update to Congress and started to flesh out the way the Fed might start to taper stimulus, bond traders panicked, sending rates higher, and rates continued higher after the release of the latest Fed meeting minutes and after Bernanke's June news conference outlining a possible tapering plan. 10-year Treasury bond prices ended the quarter off their low prices, but rates ended the quarter around 2.50%, reflecting a rise of more than 100 basis points since April. Other types of bonds performed even more poorly, with high-yield bonds performing the worst, as represented by the high-yield ETF iShares iBoxx High Yield Fund which fell from an all-time high of 95.30 on May 8th to a low for the year of 87.8 in late June (a fall of 7.9%) before recovering some at the end of the month. International bonds performed very differently depending on location. Emerging market bonds had their worst drop in almost five years, with the JP Morgan Emerging Market Bond Index dropping almost 10% from multi-year highs seen in early May, which the *Wall Street Journal* characterized as "[reminiscent of] late 2008, when emerging-market bonds fell almost 30% in less than two months." Developed world debt performed much better than emerging markets, fuelled by flight to quality buying of Northern European sovereign debt and bargain-hunting among Southern European sovereigns.

Other Markets

Few international stock markets were higher – the Dow Jones World Index (excluding the US) was down 4.0% for the quarter. Like the US markets, Japanese stocks were the only real port in the storm during the second quarter – they were up 8.9% during the quarter, by far the best performance of any major market in the world; only some small markets (UAE, Pakistan, etc.) were up more (over 10%) during the quarter. Larger markets were mostly down: Germany's DAX index was down 0.7%, the UK's stock market was down 2.6%, and China's stock market was down 7.0%, although Hong Kong listed stocks were only down 6.4%. The poorest performers were countries in economic distress (Peru down 19.1%, Argentina down 10.2%, Cyprus down 5.6% even Brazil [inflation problems] down 10.5%) or countries in political distress (Egypt down 10.0% and Turkey down 10.0%). All-in-all, it was a quarter that suffered from the threat of falling liquidity and renewed economic uncertainty worldwide.

Going Forward

The tumultuous second quarter has continued into the third quarter, as gyrating financial markets combine with mixed worldwide economic results and ever-changing perceptions of central banks' motives and future moves. We think there are large changes in store in most financial asset categories and will be examining each of them below.

Equities

While we see a lot of headwinds for equities forming, we also acknowledge that there is so much momentum in the US stock market right now that few things seem to slow it down. Thus, we believe the market could continue to rise during the 3rd quarter due to: 1) investors worldwide raising their exposure to US stocks due to their strength, 2) bond prices continuing to weaken, and 3) the Fed continuing their monetary stimulus.

We do see some factors that will exert their pull on equities at some point this year: 1) slowing growth in profits and stagnant or falling profit margins (of which there was plenty of examples during 2Q earnings announcements during July), 2) the deficit /debt ceiling fight coming back this fall, 3) realization that the reduced deficit this year was mostly caused by profit taking in 2012 in front of large tax hike, and that dividend yields are not going to continue to be as high as last year, and 4) sequestration and a slow-growth economy will continue to produce sub-2% growth throughout 2013, far lower than previously forecasted and causing doubt about current equity levels due to valuations.

Energy

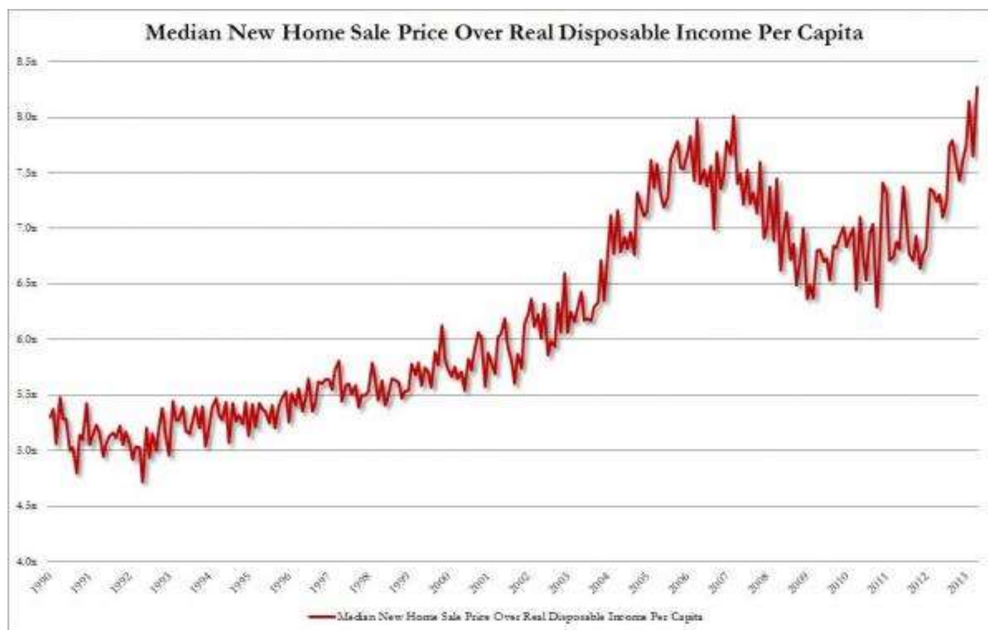
Crude oil prices continue to amaze a lot of people, including us. The rise of WTI crude prices to near $110/bbl in mid-July, eliminating the discount to Brent crude, and in strong backwardation (where current prices are higher than future prices) shows that US-produced crude is in high demand is expected to stay that way at least for the next few months. As mentioned above, energy equities have not kept up with the rise in crude oil prices, possibly because high crude prices have led to high gasoline prices, which will eventually hurt demand, and possibly because natural gas prices have weakened during the second quarter, mostly due to average weather. We believe the strength and dynamics of the crude oil business will continue, mostly due to the inability to produce at higher volumes in many other traditional producing regions (the Middle East, Latin America, Russia, etc.) and crude demand continuing to grow in emerging markets in future years. However, we are concerned about a nearer-term back-up in prices, possibly due to a "wash-out" in Europe, a financial explosion in China, or a weakening of economic activity in the US. In domestic natural gas, we believe there is still plenty of producing capacity and that prices won't have the ability to exceed

$5/MMBtu until we see how full storage gets in October/November and how much flowing supply will be available next winter.

Other Markets

Bond markets have priced in a tapering of US monetary policy in the fall, so they may get a short-term boost if/when the Fed decides not to taper in September. We also expect that the ECB will have to stop the fall in its monetary base and start to ease more, confirming easier ECB monetary policy that has only been hinted at in the past year. Thus, we believe we may see a fall rally in bonds (and a fall in bond yields). We also believe that any rally will be temporary as the markets believe less monetary easing will be offered in the future. Thus, in the short-term, we may see lower yields, but in the medium-to-long term, yields are definitely headed up.

This is bad news for housing, because it had been climbing so much in the past couple of years. Higher rates will have a detrimental effect on house prices, as recent higher prices have only been available because of ultra-low mortgage rates. Absent low rates, housing becomes a lot less robust, as is shown in the following graph and description from ZeroHedge on 5/28/2013: it shows that since home prices have risen and real disposable income per capita has not, "… it would imply that not only are homes the most unaffordable they have ever been, but that the cheap credit propping up the housing market is bigger than it has ever been in history."



This unfortunately has been confirmed by recent mortgage applications: again, as reported by ZeroHedge, "[As of July 17]…[f]or the 9th week of the last 10 mortgage applications fell (led by refis - down 55% from their peak). Now **down an incredible 45% from its May highs - the largest 10-**

week plunge since December 2010 - overall mortgage activity is languishing around the lowest levels of the post-recession 'recovery' [emphasis original to article]. This is a rather dire and sudden change in the dynamics of what formerly looked like a healthy recovery in the housing market.

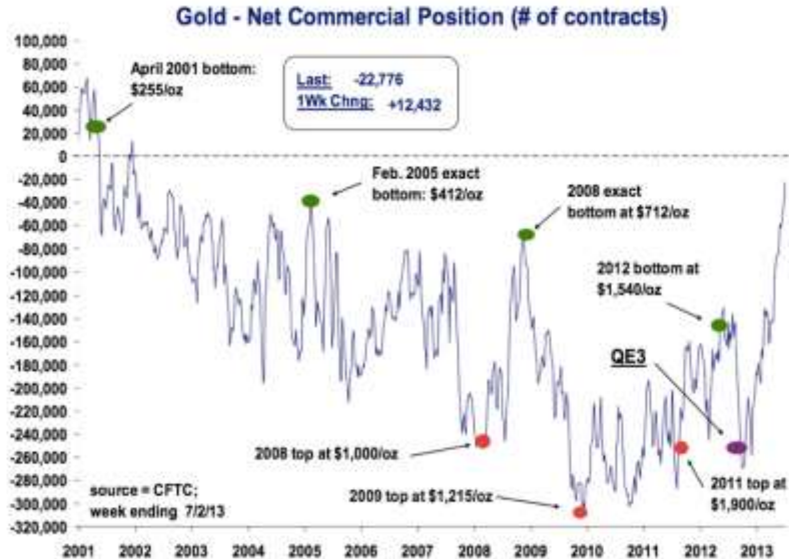
Precious Metals

Precious metals had their worst quarter in decades in the second quarter as negative sentiment, booming equity markets and a "high" in trust in central banks combined to compel a large number of investors to divest their precious metals holdings and equities. However, in spite of the price drops we saw during the quarter, there are a number of indicators starting to be embraced by the markets during this third quarter that point to a bright future for the metals and precious metals mining equities:

1) **As discussed above at length, most of the world's influential central banks are following extremely easy monetary policies, which are detrimental to the value of currencies in general and historically have benefitted gold and silver.** While this has been in place for a number of years, it is crucial to keep in mind that excess additional liquid reserves in the banking system, as well as those that are going into worldwide economies, have historically always been inflationary, especially as they are continuing to increase in size (mostly notably in the US and Japan, two of the three largest economies in the world), which only adds to inflationary pressure over time. As part and parcel of these policies, real interest rates continue to be negative around the world (inflation exceeds the amount of interest paid on fixed income investments and cash), so that investors with money parked in cash or short-term bonds are losing purchasing power. Historically, precious metals have helped preserve investors' wealth.

2) **There are a lot of indicators that show that metals are poised to move up in price in the very near future:**

a) ***Most powerful among these indicators is the aggregate position of the "Commercials" category as tracked by the US Commodity Futures Trading Commission***. The Commercials are the banks and middlemen who buy physical gold from producers and other suppliers and sell to investors and end-users, generally hedging these positions on the US futures market. Thus, they are considered "the smartest" participants, because of their history in the business and their ability to see what producers and investors/users are doing and what they are thinking. Generally the Commercials are short futures to hedge their purchases of physical metals before selling them to investors/end-users (after which they buy back their short futures position). **Currently, the Commercials have their smallest short position in gold since 2001 when the current gold bull market began – this means that in aggregate the Commercials are the most skewed toward bullish conditions in more than 11 years.** The following chart, produced by Eric Pomboy, founder of Meridian Macro Research, and displayed on kingworldnews.com, eloquently shows the Commercial net futures position and key dates in the current bull market. When the smartest guys in the market are the most bullish they've been in a decade, we take notice.



b) ***In mid-July, the interest rate charged to swap gold for dollars (the Gold Forward Offered Rate or "GOFO") turned negative for the first time since November 2008***, when a scramble for physical gold during the financial crisis launched gold on it next bullish leg higher after its earlier 2008 correction. Here is a description from The Golden Truth blogspot (truthingold.blogspot.com):

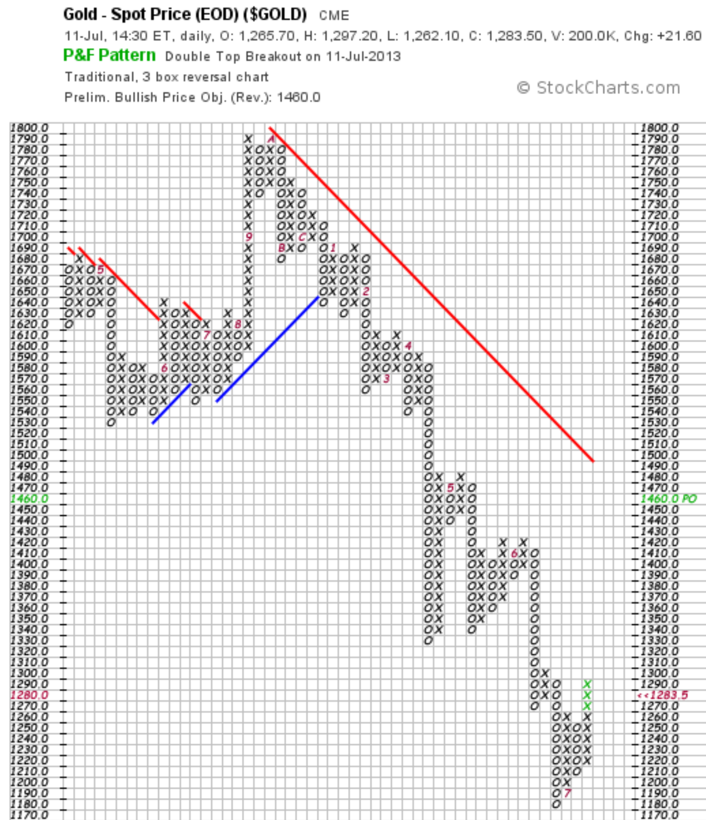
> "Something curious and very rare has occurred in the "bowels" of the gold market. The Gold Forward rate (GOFO) has gone negative. **This has occurred only four times in the last 14 years. Each time a negative GOFO has been connected to significant bottom in the gold market**: in 1999 a secular transition from a 20-year bear market into a yet-undetermined in length bull market; in 2000 [through] 2001 it correlated with a move that [led] to the 1st cyclical bull market high of $1020 in 2006; in 2008 it correlated with the price correction from the 2006 high and marked the climb to the all-time record cyclical high of $1900 in 2011; and now.
>
> **"A negative GOFO rate means that gold in hand today is worth more than U.S. dollars in hand. Think about that the next time someone tries to explain to you why gold has no value.** This is a sophisticated transaction being executed by sophisticated banks. They are not in the business of leaving money on the table for others. If they are willing to pay money to get their hands on gold, it means they are placing a higher value on gold than on dollars. That's just the law of the time value of money in action." **[Emphasis ours – KS]**

c) While some technical market indicators are still negative for precious metals, most notably that each metal is trading below all of its moving averages, ***there are some technical indicators that the metals have bottomed:***

i) on May 20th and again on June 28th, ***the physical metals (as represented by the largest ETFs which hold bullion for investment, GLD for gold and SLV for silver) as well as many of the***

large precious metals mining companies executed "key reversals", where the security sets a new low for the move early in the day, but then rises and closes above the open and close from the day before, with the June occurrences happening on large volume. A key reversal is a chart pattern that usually signals that selling is exhausted because after a new low is reached, the up volume overwhelms down volume to the point that it eclipses even the activity from the day before. When accompanied by high volume, a key reversal typically means that formerly reluctant buyers rush into the market, encouraging buying by bullish investors on the sidelines. Having it occur in May was hopeful, but having key reversals occur again in June on large volume tends to confirm the bottoming action of earlier, helping convince the market that a bottom has been reached. A number of formerly cautious analysts we follow became immediately bullish after the June key reversals, calling on subscribers/readers to treat this bottom as a watershed low that should mark the bottom of this large correction.

ii) Mid-July price action has caused another ***technical chart, called a point-and-figure chart, which uses price movements to produce future price objectives, to turn bullish for the first time in months*** (as shown below) with its initial price objective of $1460/oz:



d) ***Another recent indicator that may indicate a resumption of gold's bull market in the near future is the nature of the gold trading market in early July.*** Starting in March (before the big price drop in mid-April), large amounts of physical gold have been sold into the Chinese market as measured by

historically high gold imports into Hong Kong (March saw 138 tonnes move, a record monthly amount that was followed by 80 tonnes in April and 109 tonnes in May, double the amount from the 2012 Jan-May period).

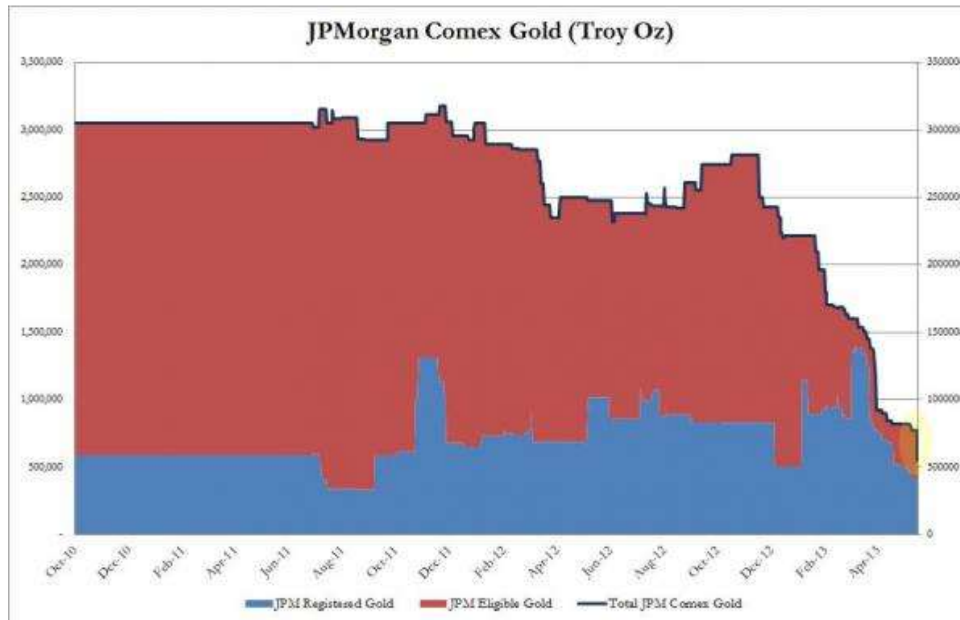
e) Another bullish indicator that should contribute to higher gold prices is ***falling gold production due to low prices and deteriorating operating and/or political conditions***. One of Wall Street's old sayings is: "the cure for low prices is low prices"; so as prices have fallen, some high-cost mines have been forced to either cut production or close entirely. Newcrest Mining in Australia, with some of the higher cost mines in the world, has announced production cutbacks at some of those mines. Other smaller producers have announced mine closures, including Oceana Gold in New Zealand, Yukon Zinc's silver production in Canada, and others. South Africa, formerly the largest producer of gold for decades, is now the "problem child" of the industry: Statistics South Africa reported in early July that May gold production was 14.6% lower than in 2012, and 2.4% lower than April 2013 output. South African companies like Harmony Gold and Sibanye (formerly Goldfields South African properties) have announced cutbacks, while other mines have experienced strikes and labor unrest leading to less efficient operations, higher prices and production uncertainty. This is exacerbated by uncertain power production by South Africa's notoriously poorly run and undersupplied electric utility, Eksom, which is struggling to provide enough power for both citizens and industry due to chronic underinvestment and poor management. In summary, with lower prices, higher costs, labor unrest, poor operating conditions, and occasional power outages, "…about 60% of the [South African gold] industry is in loss-making territory," according to Roger Baxter, chief economist at South Africa's Chamber of Mines, in a 7/7/13 interview with Reuters. Thus, we believe lower production volumes will affect supply expectations, helping prices through supply/demand adjustments, and this highlights why we avoid investments in South Africa.

e) ***Financial market action also helped identify a contrarian indicator: the bearishness toward precious metals and mining stocks reached extremes at the end of the second quarter***. Mark Hulburt, in his market sentiment newsletter, reported that **gold advisory newsletters were as bearish as they have ever been, advising clients to be net short gold or gold equities** during the second quarter. John Doody of The Gold Stock Analyst reported that by his historic measures, gold stocks are trading at an all-time low valuation on 7/1/13, trading at a 45% discount to historical levels with gold in the low-$1200s/oz. These three factors alone argue for a large contrarian retracement in gold and gold equities prices as financial markets almost unfailingly show reversions to the mean (higher valuations, in this case) with the abovementioned indicators showing such extreme readings. Tino Sarantis of the Bank of Italian Swiss, in the 7/3/2013 The Gartman Letter, relates some extreme statistics of the low valuation of gold miners compared to historical patterns:

> "I have arrived at the same [bullish] conclusions [regarding the extremely low valuation of the gold miners]…[l]ooking at the NYSE Gold Bugs Index which has a longer track record than the Miners ETF [GDX] and comparing its price to physical gold, shows that in early 2001 [the beginning of the current bull market in gold] the ratio was 0.2…this ratio peaked in 2003 at 0.64. Although gold miners continued to rally, the ratio actually began to trend slightly lower for four years, before collapsing back in 2008 to 0.2. The ratio rebounded in 2009 and 2010 to 0.4 and then corrected aggressively. Last week on 26 June, the ratio of the [Gold Bugs mining] index

(HUI) to physical gold touched a low of 0.16 – the only time it has ever been lower was for the briefest of periods at the end of 2000 and beginning of 2001 [when the gold bull market started]!"

f) ***In addition, while physical demand (mentioned above) skyrocketed in April and continued its strength into May and June, price weakness has brought out apparent large scale accumulation of physical gold by larger holders***. Much of the physical gold is thought to be moving to China, India and other Asian countries, implying supply for Western investors may become scarcer and may not be available in the future when demand for gold again picks up. Aggregate Comex inventories, which are the warehouses that hold gold for delivery into the Commodity Exchange (Comex) gold futures market, have seen their inventories plunge in 2013. Comex inventories were at a near-record 11 million ounces in mid-2012, but since late 2012/early 2013, they have plunged to under 7 million ounces – not the reaction you would expect as prices fell. In addition, according to Bloomberg, total ounces held in Gold ETFs have also fallen as gold prices have fallen since late 2012; total Gold ETF holdings have gone from approximately 83 million ounces in early 2012 to under 65 million ounces in mid-2013. Hong Kong gold imports are generally considered a proxy for gold being imported by China; according to Reuters, Hong Kong imports in May amounted to almost 109 metric tonnes, the second highest on record, taking the 2013 five-month total to 431 metric tonnes versus 832 metric tonnes for all of 2012. We believe the movement of so much physical gold to China and India have constrained supplies for the West; as continued Western central banks' money creation pushes more investors toward precious metals in the future, we believe the diminished stocks of Western gold will force prices higher as investors scramble to find physical gold (mining stocks should rise at a higher rate as their reserves in the ground are re-priced higher). Here is a graph of the holdings of the JP Morgan gold vault, courtesy of ZeroHedge.com:



g) ***Finally, gold and silver should be expected to benefit as supposed "safe haven" investments (like US Treasuries have done) but instead have shown more underperformance***. Since 2007, when

stocks, commodities and other investments have underperformed, many traders and investors either "went to cash" or sold and put their proceeds into US Treasuries. These were both considered "ports in the storm" (as was gold for millennia, just not as much in the last couple of years). However, we know that money market funds (which were considered the same as cash by many) had problems in 2008, to the point that the government had to come in and guarantee them for a time; and T-bills, very short-dated Treasuries, were in short supply and barely available through bond mutual funds because they didn't pay enough to cover management fees, much less provide a return for investors. So, that left US Treasuries as the safest of the safe. As most of us know, Treasuries had the worst quarter in years as the threat of a slowdown in monetary stimulus led to losses in 3-year all the way out to 30-year bonds, causing some panic in investors who had considered that Treasuries never threaten your principal (that is only true if you buy at or below par and hold them to maturity). Bonds are vulnerable because continued Fed purchases may buoy bonds short-term, but the newly-created reserves add new money to the system, depressing the US dollar and contributing to increasing inflationary pressures. So a large number of complacent investors have now had to consider whether even US Treasuries are safe for the time frame in which they are parking capital. Finally, throw in the "Cyprus solution", where large depositors participated in some of the losses of the banks, causing what were thought to be "safe" deposits to take a big haircut. We feel in this scenario that gold again will be recognized as one of the most desired assets for safe haven investing. The losses taken this quarter by some Treasury investors is a new and important factor in what will be a large move up in prices for the precious metals.

Kanos Quarterly Commentary

This quarter, due to the length of the letter, we will have two abbreviated sections of the commentary.

1. What IS that? InFLAtion?

One of the main tenets of the current bullish advances in financial markets has been the ability to stimulate with an absence of inflation. I am sure that we have harped on inflation too much in our letters, but in our personal and professional lives, we see the presence of increasing inflation and find the official figures being reported as more and more fanciful.

While we understand that economic forecasters tend to have some large biases toward and against certain large "levers" of inflation, we tend to think that inflation must be considered "holistically", not just in the context of what the Fed and governmental authorities believe would be a good yardstick for measuring what they think should be called inflation.

Intuit, which produces best-selling financial software products Quicken, QuickBooks and TurboTax, has put together The Intuit Spending Index which is based on anonymized, non-identifiable aggregated data from more than 2 million Mint.com users, a financial planning website owned by Intuit but enhanced from data Intuit has from its 45 million customers. According to the company,

"the data has been analyzed and normalized to create a statistically relevant view that better represents the average American household." The index measures spending habits from January 2009 forward, and using data from 1Q 2011 to 1Q 2013 (the last two years, with a small lag), expenses of Americans have changed in the following ways:

Kids' activities	+118%
Health insurance	+111%
School tuitions	+70%
Babysitters/daycare	+65%
Education (adult)	+39%
Utilities	+35%
Baby supplies	+23%
Groceries	+6%
Toys	+2%
Home	-27%

These are some huge increases! It would appear that inflation is not only alive and well, but very high. So why aren't these types of increases found in US official inflation statistics?

Namely, US financial authorities have traditionally only acknowledged inflation when it appears in the form of wage inflation because of the large number of wage earners in the US economy. Obviously, with the large amount of unemployed in the US since the 2008 financial crisis, pressure on wages has been less than historically seen in this stage of economic "recovery", but this time it is for a number of reasons: 1) fiscal uncertainty that survives from the financial crisis has led to less capital investment by American (and worldwide) businesses which has led to less full-time hiring due to future order uncertainty, 2) the inclusion of India, China, Russia and other formerly "closed" countries in the 1990s led to a secular rising supply of skilled workers with lower pay needs, the influence of which continues today, 3) new fiscal/regulatory constraints, most notably Obamacare, have led to less hiring than might be forecast, and more part-time jobs (which don't require health insurance and other benefits), and 4) the past hikes in pay and benefits for public sector union workers now put them at the higher end of many pay scales, lessening a force that historically pushed for higher wages as soon as a recovery took shape. But many of these factors are starting to change: overseas economies have experienced much higher inflation than seen in the developed world, and there are strikes and other serious pushes for higher wages throughout much of the rest of the world. And, of course, these statistics don't usually include food and energy because they are considered "too volatile" to help spot a trend. Since they have for the most part been headed up for the years since the financial crisis, they contribute to inflation felt by the consumer but disclaimed by economists and the financial press. Finally, in the 1960s/1970s, housing also experienced inflation, which contributed to the large inflation experienced in the 1970s, but that also is no longer considered in the computation of inflation.

All we can say is we see inflation in lots of places, even the price of a **movie ticket** – in Houston, Texas, a move now costs $11 per ticket! As recently as 2011, the average US ticket price was around

$8 (according to natoonline.org), meaning that prices (assuming Houston is a typical market) have risen 37.5% in the past two years – and there is no inflation?

2. Are We Letting Them Do It Again?

We are constantly analyzing financial markets and news to try to find things that will affect our portfolios and possibly lead to new investment themes or ideas. We have spotted some articles lately that really make us shake our heads and wonder if we are headed for another crack-up sooner rather than later. Read on and wonder.

Obama Administration Pushes Banks to Make Home Loans to People with Weaker Credit

(Washington Post) 4/2/2013 – "The Obama administration is engaged in a broad push to make more home loans available to people with weaker credit, an effort that officials say will help power the economic recovery but that skeptics say could open the door to the risky lending that caused the housing crash in the first place…President Obama's economic advisors and outside experts say the nation's much-celebrated housing rebound is leaving too many people behind…Officials are also encouraging lenders to use more subjective judgment in determining whether to offer a loan…"

Austerity Is Not the Only Answer to a Debt Problem

(Financial Times) 5/1/2013 – Kenneth Rogoff and Carmen Reinhart offer a number of reasonable parts of a solution, including writing down bad debts of financial institutions and structural fiscal reform. But they also include this: "…One of us [Rogoff] attracted considerable fire [recently] for suggesting moderately elevated inflation (say, 4-6 per cent for a few years) at the outset of the crisis. However, a once-in-5-year crisis is precisely the time when central banks should expend some credibility to take the edge off public and private debts, and to accelerate the process bringing down the real price of housing and real estate…" [***We say, shame on you, Ken Rogoff, for suggesting one can "turn on" 4-6% inflation and then just turn it off – inflation, once ignited, is extremely difficult to "turn off." In addition, firing up inflation basically steals more from savers to make debt more affordable, no matter how recklessly incurred – KS editorial]***

Europe's Banks Turn to U.S. Subprime for Salvation

(Bloomberg) 5/28/2013 – "The U.S. mortgage bonds that were exported around the globe and triggered the worst financial crisis since the Great Depression are now helping Europe's banks and governments repair balance sheets after jumping in value."

New Bait for the Old Office of JPMorgan's London Whale

(Fortune) 7/18/2013 – "…According to several people familiar with the deals, JPMorgan's London chief investment office, which last year lost more than $6 billion betting on credit derivatives, is in the process of inking deals to buy significant portions of collateralized loan obligations [CLOs], which are structured bonds that are backed by groups of loans to below investment-grade companies…CLOs are

not the derivatives that are in part credited with blowing up the mortgage market [in 2007-2010];…[t]hose are collateralized debt obligations, or CDOs, which were backed by subprime home loans. But CLOs are close cousins."

These articles show a lot of bad ideas and actions coming out of "status quo" institutions that were either responsible for many of the problems which led to the financial crisis, provided regulatory reasons for bad business decisions, or were bailed out during the crisis after making poor decisions.

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