KANOS CAPITAL MANAGEMENT, LLC

June 2010 Investor Letter

Second Quarter Market Conditions

Generally, the US stock markets traded in a wide range during the quarter: April continued the year-long stock market run with economically-sensitive stocks and commodities hitting their highs of the year. As economic statistics in May started to show that the economic rebound might be faltering, financial markets turned down as did most commodities. Continued poor economic reports caused more selling during June, and traders and investors moved money to safer assets, causing gold to reach all-time highs and bonds to multi-year highs.

April saw stocks and commodity prices continue their year-long advance as economic statistics and corporate results for the first quarter showed continued [albeit small] growth in the US economy. Continued strong growth in the world (especially Asian) economies propelled commodities and economically-sensitive sectors.

May was another story – economic statistics leveled off or started to drop, doubts about Europe (their economies, the political/monetary situation, etc.) came back into the market, and the "flash crash" where the US stock markets moved down almost 10% in less than an hour then recovered much of the drop in the next hour led to a continuing sell-off in the market for the rest of the month. Finally, the BP Gulf spill disaster went from being a minor story to major when the spill was not capped and BP (and associated stocks Transocean, Anadarko, Cameron, Halliburton and most non-affiliated energy stocks) led energy stocks, and the market in general, down to new lows for the year.

June saw "see-saw" action as bouts of optimism and pessimism drove the market up and down on many days during the month. June sold off late though, and the US markets had their worst quarter since the 2008-2009 financial meltdown.

Emerging country stock markets also had poor quarters, and investors lowered their risk positions and sought developed world bonds and currencies. China, India and Brazilian markets were notably weak during the quarter. Australia and Canada, even with strong economic results and increasing employment, saw their currencies fall against the US dollar (and against the yen), as capital flowed toward liquidity.

The bond market was dominated by concerns in Europe which led to a slow move up in bond prices (down in rates) to multi-year highs as US government and high-quality US corporate bonds were sought as havens. European bonds, while stabilizing, stayed at low prices/elevated yields, and lower quality bonds (both corporates and sovereigns) sold off around the world.

Precious Metals

While much of the market made yearly lows, gold prices moved up to new records in the mid-$1200s/oz twice during the quarter, pulling up gold mining stock prices with them. Silver prices, while setting new yearly highs, were buffeted more with the rest of the financial markets due to silver's industrial demand concerns; thus, it did not hold its gains as well as gold. Gold finished the quarter around $1240/oz, while silver, after reaching $19.50/oz in May, ended the quarter near $18.50/oz. Platinum and palladium, after reaching new highs in April, ended down for the quarter as investors grew more concerned about industrial growth around the world, especially automobile sales which are the main influence for platinum/palladium demand.

Energy

Oil prices were in the $80s/bbl during April, but the reappearance of worries about the global economy, especially in the high-energy-usage-per-capita developed world, coupled with spill-related capital fleeing the energy sector, led to oil plummeting during May. Oil fell from the $80s/bbl to the high-$60s/bbl by the end of May, but June saw prices move up to the mid-$70s per barrel as higher usage, better supply-demand balance and concerns about longer-term supplies out of the Gulf of Mexico supported prices.

General Stock Market

Technology, financials, healthcare, retail and industrials all joined energy stocks falling during the quarter. Our avoidance of most of these sectors (and our having a Canadian bent toward our energy positions) allowed us to avoid much of the carnage which happened in the general stock market. Technology was conspicuously weak as large players switched from a "buy the dips" trading strategy to a "sell the rallies". The market, after peaking on April 26, could not hold above its lows last hit in February (around 1045 on the S&P 500 during June which was considered a key "technical analysis" support level), and the quarter ended at new lows for the S&P 500. Precious metals stocks, following rising gold and silver prices, outperformed the market by a wide margin.

Investing Going Forward

While the general landscape looks bleaker than it has in at least a year, we still think the market will hold up in the short-term for a number of reasons. The chief reason we think the developed worlds' markets will not fall and stay at low levels for months is that we believe the leveling off of both the US and European economies will draw an "easier money" policy response which will serve to reignite investors' appetites for equities. We believe the monetary response will include US (and some European) purchase of bonds in a new installment of "quantitative easing" (or as financial commentator Bill Fleckenstein has dubbed it, QE2 [like the ocean liner]). QE2 will serve to introduce more liquidity and further lower rates in highly-rated sovereign bonds (US, German, French, even Japanese), further pushing investment capital into higher yielding (and higher return potential) equities. Secondly, we believe that the ongoing economic growth in the developed world, most notably in East Asia but also in South America) will continue to keep developed economies from "tanking" with slowly increasing demand for US/European exports and a steady diet of low-cost imports for the cash-strapped US and European consumers. Additionally, we think that the rhetoric emanating from Europe about austerity measures will be mostly talk and little action, as flagging economies and vocal constituents put pressure on politicians to keep money moving into public spending projects and support/transfer payments for struggling industries and individuals.

However, longer-term (which could be as soon as this fall), we believe that the markets will "look through" and see that policy responses are only short-to-medium-term, and that US and European economies are not growing appreciably. The Democratic Party-controlled US government has also shown its single-mindedness toward its long-standing policy agenda, mostly ignoring the economic ramifications (or paying lip-service to them), so the November elections could be momentous in that they could strip the Democrats of their ability to advance any more of their policy agenda; the possibility of this is also a support for the market. If the Republicans don't appear to make significant inroads in the US Government, the market could decline significantly.

Housing, which seemed to stop dropping in price during late 2009/early 2010, looks like it could have another "leg down", as more rate re-sets push more houses into an already-glutted marketplace full of foreclosures and short-sales from bank inventories. The market has recognized the weakness in housing as homebuilding stocks dropped precipitously starting in late June. We think that 2010 strength in employment in Australia and Canada, coupled with economic strength in East Asia (as shown by continued monetary tightening in Australia, China, South Korea and even India) and Canada, shows that countries see their economies growing enough to remove supports. This means there will be stocks from these regions that do very well, but others that do poorly (luxury exporters, suppliers to consumer-discretionary companies, etc). This economic strength also means that commodity prices will probably show times of strength (but also times of weakness), meaning there will be extreme volatility in financial markets, even more so than we have seen recently.

Gold and Precious Metals

As gold has climbed in price, we have heard from many quarters that gold is in a bubble because “everyone” owns some now. What has been less noted by many of these “recently-minted experts” is that gold has started trading on more of an ‘inverse-Euro’ basis, meaning that weakness in the Euro has meant higher gold prices, and vice versa. This has meant gold has traded in tandem with the US dollar, not inverse to it, as in the past. This is because Europeans and other Euro-holders have embraced gold as another alternative currency to the Euro, and as people move out of Euros, increasingly they are buying gold. If developed countries institute QE2, those currencies (most probably the US dollar and the Euro) would be expected to fall in value (as the supply of them rises), further driving up gold prices. In addition, if volatility stays at recent levels or increases, as we expect, then more traders will move towards more safety and upward trending assets, like gold.

Silver, although a more industrial precious metal (and more volatile in price) than gold, is increasingly considered a precious metal, as investors looking for stability look for assets that will hold value in a time of increasing uncertainty. People buying coins have bought so much silver that it increasingly seems in short supply. Platinum and palladium are used in such great amount by the worldwide automobile industry that their functioning as precious metals is less effective, as recent weakness due to flagging auto sales has shown. But we expect silver prices to move to new highs with gold this year, and thus we will maintain or build our positioning in precious metals ETFs and mining shares.

Energy

Energy is a much more difficult analysis because of the competing short-term fundamentals – slow-or-no-growth developed world versus slowly deteriorating supply. Oil statistics have been showing a tightening supply-demand balance, and the moratorium on Gulf of Mexico drilling should contribute to lower deliverability. In addition, the uncertainty associated with GOM drilling has increased oil market price volatility (if that’s possible), which will contribute to lower drilling expenditures as companies drill less due to higher risks and higher potential costs. The GOM moratorium should help at least one oil province: the Canadian oil sands; the oil sands are outside of the reach of the US Government and are considered the future of the Canadian oil industry. There have been a number of deals recently where larger, more cash-rich companies have bought stakes or properties for development in the oil sands. Our positions there should appreciate in value (both relative and absolute) over time as oil gets harder to explore for around the world.

Oil has not been able to break out above its highs from April and the contango (the increment between monthly prices) has stayed wide, causing many analysts to predict lower prices in the future. In spite of this, oil has stayed above $72 for the last few weeks, and we believe that crude oil prices will hold in this range or appreciate as developing countries' demand continues to build and worldwide deliverability continues to slowly slide, accelerated by increasing governmental/environmental "friction" in being able to explore for more supplies.

Natural gas, both domestic natgas supplies and worldwide LNG supplies, appear to be in extra supply as prices seesawed during the quarter between $4.00-5.25/MMBtu. We have shied away from natgas investments lately because of these oversupply concerns. However, in spite of its huge impact on psychology and pricing, shale gas only makes up around 12% of domestic gas supplies. LNG has not shown up in large quantities in the US as had been expected either, although it seems that there is more LNG deliverability coming on this year and early next year. Noted forecaster Henry Groppe believes the rapid drop-off in first year deliverability of shale wells means that shale gas will have far less effect on domestic gas supply deliverability, meaning that domestic natural gas prices will move back up closer to $8/dth this year as supplies get tighter. Call us skeptical, but we aren't betting against it either.

Kanos Quarterly Commentary

"What Has Happened Financially (and what can we do about it)"

The developed world has gone through a historic economic slump that continues to have sharp aftereffects on how economies are functioning and business is getting done. However, in spite of calls that the recession is long-over, most of us can either see or "feel" that things are not "back to normal" and that any economic recovery is slow and uneven. The things that keep bugging us at Kanos can be boiled down into two main thoughts: 1) Why has this happened? and 2) What can we do about it (economically and from an investment perspective)? This quarter we intend to put forth some of the things that we believe have gotten the US (and much of the world economy) "off-track" and must be done to rectify it, at least in the US (and maybe Western Europe). So pull out your blankets, snuggle up on the couch, and get ready for a rant.

It didn't have to be this way. The United States in the early 1980s had emerged from the 1960s and 1970s having survived an experiment with overspending and large federal deficits (the JFK/LBJ "Great Society" and "guns and butter" eras) trying to expand social programs and fight expensive overseas wars. While investors made money through much of the 1960s, the bull market of the late 1950s/1960s topped out for the most part in 1966 and the euphoria of the "Nifty Fifty" stocks marked the move towards the subsequent bear market. The "hangover" during the 1970s, characterized by inflation and caused by 1960s finances and the economic malaise that occurred from foreign competition, poor fiscal decisions and wildly inflationary Federal Reserve policy, meant a lost decade for investors. The collapse and revamping of Rust Belt industries and the foundation for the modern technology sector occurred during the 1970s, but the abovementioned government bungling and investor caution and uncertainty meant the stock market went nowhere. Investors concerned about their wealth instead concentrated on protecting their assets from the government (taxation and onerous regulations) and from the Fed (loose monetary policy that led to rapid inflation and erosion of dollar purchasing power).

But Paul Volcker, the chairman of the Federal Reserve starting in 1979 [and a Democrat], broke the back of inflation (though it caused back-to-back deep recessions in the early 1980s) and the free market, business-friendly policies of the Reagan Administration coupled with its tax-cutting policy revitalized American business, and the markets went on a multi-decade tear, unlocking wealth that would be considered sheer fantasy only a decade earlier. The late 1980s/1990s were a time of re-emerged dominance of American business and finance. US businesses grew their worldwide market share and profits as new technologies and new business systems worked their innovation and productivity “magic”.

So – what went wrong? There was a shadow over the post-1991 recession, boom time 1990s: the US government did not use this new-found abundance to shrink government’s headcount, deficits and national debt. In spite of Congressional Budget Office official projections that the US would run budget surpluses in the late 1990s and 2000s, government proceeded to spend the surpluses rather than cut all things while times were good. The boom ended with the “blow-off top” of the internet bubble which caused a recession in the early 2000s and led the Federal Reserve to a massive ultra-low-interest rate monetary response. The resulting easy money policy of the Fed, coupled with the governmental encouragement and newly-lax requirements for home ownership, led to the massive housing boom of the mid-2000s and the inevitable bust following, which touched off the financial meltdown of 2007-2009, which had started with problems in subprime mortgages.

Resultant Problems

Thus, we have a number of long-term ingrained problems brewed during the time described above that plague us and will take a long time to recover from:

1) **Easy money policies of the Greenspan/Bernanke Federal Reserve** – unfortunately, the monetary policy responses to the last two recessions has been to significantly lower rates and to keep them (too) low for longer than needed. It has ended up allowing governments and businesses to overleverage to a dangerous extent. Something must be done to better administrate the financial system and probably the best response would be to abolish the Fed and let the market set interest rates.

2) **The build-up of debt, both private and public** – following on #1 above, the extreme amount of debt on governmental and financial company balance sheets is monumental and potentially very destabilizing (yes, even from current levels). Lawmakers have allowed the country to overspend without thought; they must pass legislation to start paying off these debts (hopefully mostly through reduced spending) and put mechanisms into place to ensure that in the future this overleveraging does not occur again. Regulators must do their jobs more vigorously in the future to make sure financial institutions do not over lever their balance sheets and stay within regulatory capital limits.

3) **Lack of regulatory enforcement and the continual watering-down of financial oversight (both internal and external)** – following on #2 above, lawmakers have watered down regulations over the last 30 years (except when they put in knee-jerk legislation like Sarbanes-Oxley that does very little), but even worse, regulators have been lax or non-existent in enforcing even those laws and regulations on the books. The new "finreg" financial reform law which has just passed in Congress is mostly "window dressing" with increased regulatory and paperwork requirements to protect consumers but little that prevents the problems that contributed to the recent crisis. Congress must, at some point, put into place new, effective laws that prevent financial institutions from threatening the financial system. In addition, regulators must "keep up with the marketplace" and enforce regulations to keep financial institutions within their mandates and risk constraints. One big question that seems to go unanswered by our current "leaders": banks are allowed to trade huge amounts of derivatives while funding a large amount of their capital through government-insured deposits. The sheer amount of derivatives, as well as their virtually unregulated nature, has put the financial system at risk once already, but there seem to be few changes in the works concerning this. Why?

4) **Ballooning liability warfare led by plaintiffs' lawyers** – Tort reform has led to a much more robust business environment in Texas. Shouldn't the US Government enact tort reform, especially with respect to the medical profession, in order to bring costs down (that have been propelled skyward in recent years, due in large part to legal costs / protections)? Non-material lawsuits that have been propelled into major business issues by overzealous plaintiffs' lawyers continue to make business harder to conduct in the US; it is time to mandate maximum damages to downsize these cases to their former sizes.

5) **The abrogation of responsible corporate governance by managements and the real owners** – this is a large problem facing the public markets that has been building over the years. Managements have hijacked the reward structure for companies (bonuses, stock options, etc.) while no one takes any responsibility for non-success or failure. Boards of Directors are either proxies or limited by their scope of merely hiring and firing high-level employees. Meanwhile, pension fund and other large institutional owners (like index funds) who own the majority of corporations, exert either no or very little leadership as owners in the corporation, leaving it to management and boards. Thus, when poor results occur, management either stays or leaves but always gets paid. When things go well, management gets paid even more (even if the success is through no

"fault" of their own, such as commodity price appreciation). Owners of corporations are going to have to be more pro-active in the future as worldwide competition and the end of low interest rates makes competition much more difficult than in past years.

6) **The poor education provided to so many youths through mismanaged public schools** – the United States has fallen behind in math and science and increasingly in simple literacy because public schools are run with all the pitfalls of governmental agencies. In charter public schools where discipline, fear of failure and mandatory parental participation combine with hope, even in the most desperate cities in the US, including Harlem and Detroit, kids score high on standardized tests and go to college, which increasingly is not happening at inner city schools around the US. The reason US business is so competitive and US workers make more than their foreign counterparts is that they are much more efficient – however, less well-educated kids with lower goals threaten to lower American standards of living if we don't educate our kids better.

Immediate Problems

But those are long-term issues that need long lead times to correct. Meanwhile, there are a number of shorter-term problems facing the nation that appear to us to be in the way of healthy, sustainable recovery. We will discuss some of them and then propose some possible solutions.

1) **The Administration is badly out-of-step with business** – Democratic leadership, led by President Obama, continually says that "jobs are their number one priority", but they are actively acting in other ways to thoroughly discourage hiring:

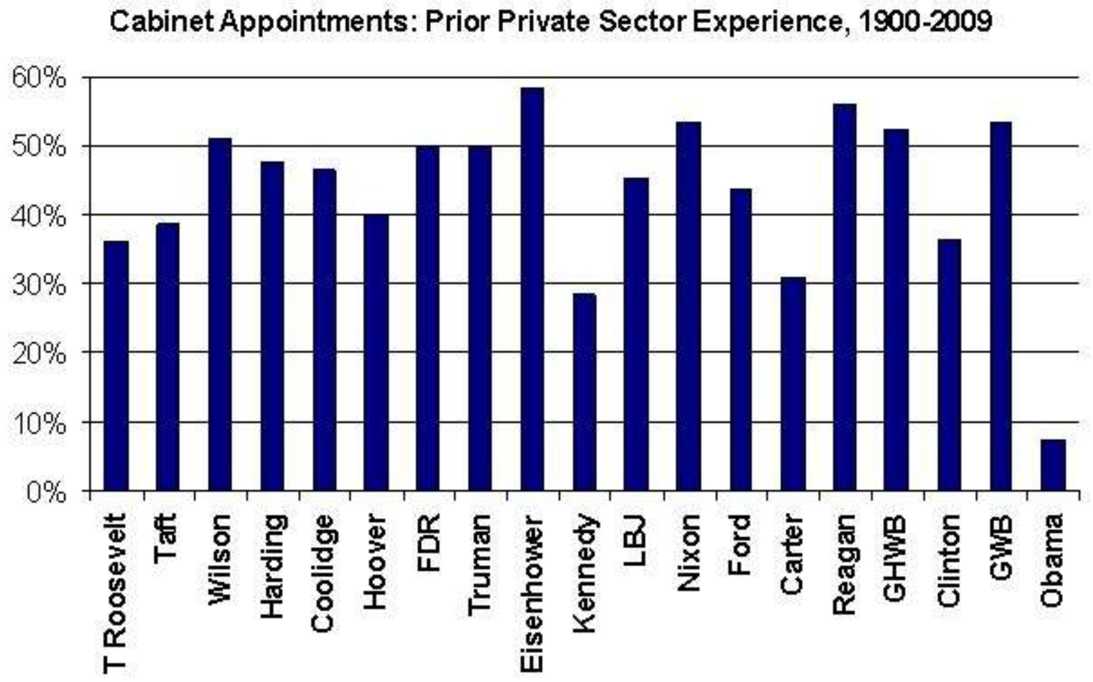
a) Meddling in business matters that are out of the purvey of the executive branch of government – examples are many, but a few notable ones were the firing of General Motors' CEO by President Obama, having government personnel appointed by the President determining which car dealers were terminated or not, appointing a "czar" to judge financial industry bonuses at AIG and other TARP recipients, instituting a broad ban on offshore drilling due to one accident, coercing BP into creating a $20 billion oil spill slush fund, etc., all of which contributes to a threatening environment for employers, causing concern about future business dealings in the US;

b) Raising taxes on US business with a number of open-ended provisions, making planning for the future impossible – the new health care legislation is the most egregious example of this, the cap-and-"tax" climate legislation currently in the Congress is another example, as is the ambiguity around the expiration of the "Bush" tax cuts;

c) Their war of words (and sometimes deeds) against a number of industries – 1) energy (weeks of vitriolic talk against BP about the oil spill, but even before that, a vilification of the energy business used to try to pass the "cap-and-trade" legislation, 2) healthcare (especially pharmaceutical) and 3) insurance, both of which came in the cross-hairs during the campaign to pass healthcare reform, and 4) financial – while we believe financials did cause a lot of our problems, they have been vilified in ways that we disagree with also, like the cramdown of mortgage forbearance/ modification and the prosecution of Goldman Sachs in the Abacus CMO case.

d) Continuing talk of "redistribution of wealth" and the undermining of confidence that this causes. Both the Democratic Congressional leaders and the Administration continually show an anti-business flair, epitomized by their "make 'em pay or take them over" slogans (and experience, in the case of GM and Chrysler).

Lack of jobs is the real problem in the economy right now, and the Administration is clueless on why the situation is getting no better. One main reason may be that the Obama administration, as represented by the President's Cabinet, has BY FAR the least amount of private business experience of any administration in the last 100 years, and by 2/3rds! As shown by the table below, less than 9% of Obama's Cabinet has private sector business experience, which trails Kennedy's 28% and Carter's 31%, the former lowest totals. Almost no one in this Administration has ever had a hand in creating private sector jobs - that is why they have been unsuccessful at it. The US public seems most angry about lack of jobs and opportunities, and it will be shown during the November elections just how mad about it they are.



2) **The financial regulatory framework is still in place and risks future meltdowns like in 2007-2009** – Large financial institutions are getting the benefit of Federal Reserve largesse in the form of virtually 0% short term rates and continued forbearance on marking assets to market, giving these banks a way to heal their sickly balance sheets – borrowing short (from the Fed at 0.25%) and lending long (either loans or government bonds), which, if lending to the US Government by buying US Treasury bonds, is credit-risk free but earns 2.75% [10-year Treasuries pay 3.00% less Fed borrowings for 0.25%]. Risk-averse savers have also given banks ultra-cheap sources of capital – deposits that earn either no or virtually no interest (due to low Fed-mandated short-term rates). These sources of very cheap capital are also used by the banks in more risky operations:

a) Banks run huge trading desks and use their capital to back large (mostly matched) positions in derivatives. While they may not always take a lot of market risk ("its going up", for example), they have market risk but they have a huge amount of counterparty risk, where if a big trading partner goes bust (think a hedge fund or a foreign bank, etc.) then our large banks could lose money when their counterparties default on their derivative commitments. In other words, the system still has a framework that implicitly contains large banks that could domino if the wrong counterparty fails – thus, the system still is too big to fail. This is only partially addressed in the new "finreg" law and much of the actual procedures are not even written yet [even though it is law!].

b) The relaxed mark-to-market and lax accounting rules make knowing what a bank owns in its portfolio virtually impossible to know and also understates capital ratios and leverage because complex assets have been carried at higher values than their true market value. To stop extreme stress on the banks in late 2008, mark-to-market rules were relaxed, but if these complex assets are overstated, then the bank does not have as much capital as the books say they do, which means they are more highly levered and means that they could have a harder time surviving another financial crisis. This goes hand and hand with the "extend and pretend" policy, where regulators have also allowed banks to extend loans that probably are not good loans, but in the interest of not further disrupting corporate credit markets – obviously at some point, these could also destabilize banks if these loans become more of a problem.

c) Large financial institutions have large proprietary trading desks and often have hedge funds and private equity funds owned and run for the firm itself. This structure, capitalized in part by FDIC-insured deposits, could contribute to the risk of large losses due to the levered nature of the hedge funds and private equity, and large proprietary trades may cause a large loss which weakens a bank's capital position. Banks owning them also creates a possible conflict of interest with customers, but that is less of a concern.

d) The financial exchanges have all been demutualized and are now for-profit entities. The emerging problem with this model is that shareholders and management of the exchanges are trying to grow earnings in a slow-growth arena and have had to find new profit centers. What they have done is sell data streams that allows tilting the playing field to big, high-frequency players (HFTs); the SEC is clueless about the advantages and profits to HFTs and harm to consumers and big pools of money (mutual funds, pension funds, non-profits/foundations), who get poor execution and out-of-date market signals and quotes – which means HFTs are taking profits out of pension funds and stock holders "pockets" and contributing to downside volatility, sometimes "stampeding" stocks like happened in the "flash crash" of May 6, 2010.

e) Financial reform (the pending "finreg" bill in Congress) is a joke – it is being set up to expand the powers of the Fed (as overseer) and Securities and Exchange Commission (SEC), but the SEC has been more a tool of the status quo powers on Wall Street than any real protector. The SEC ignored data on the Bernie Madoff Ponzi scheme and lots of other questionable activity – that the government thinks the SEC will "get some teeth" and go after the real troublemakers is laughable.

f) The blame game is so focused on trying to convict a few "sacrificial lambs" but for the most part letting the majority of the perpetrators of the financial meltdown get off scot-free by using the hollow defense of "no one saw it coming" [which is untrue – a number of investors saw it coming in some form, including us] that our society will not end up learning enough about what really went wrong (and changing those things for the better). Cynically, we believe that even if Americans did get to the bottom of the problems, politicians would be able to quash any real reforms (just as they are doing with the pending finreg bill). The campaign money which flows to our Congress is the main reason for this: lobbyists promise future monetary support or call in "past debts" to make sure their clients aren't hurt by investigations or new laws (the most egregious example of this is Fannie Mae/Freddie Mac, but it also applies to Wall Street banks and defense contractors, for example).

3) **The classical US democracy/free enterprise model has been twisted into the "everyone is entitled to retirement (social security), medical care/health insurance (Medicare/Medicaid /Obamacare), homeownership (Fannie/Freddie/FHA), and 'toys' of all kinds"** – for most of its history, America was a place where people worked to earn the means to afford the American dream – a house, a car and creature comforts. In the 2000s, too many people now feel like we are entitled to all the things that people have earned in the past. And the government has embraced and socialized this thinking, but so many people are "free riding (only about 53% of Americans pay effective income taxes – lower income people get all their taxes and more refunded) that the debt-financed welfare state is starting to get too big to finance. Meanwhile, President Obama has said (and made it quite clear) that he believes there are plenty of people in this country "who have made enough money"; the problem with that thinking is that if you limit people's incomes, who is going to pay for all the entitlements of the welfare state? The US government is spending too much time and effort to discourage income-generation. Something will have to change, sooner rather than later, and we don't think it is the "change" that Obama preached about during his 2008 campaign.

4) **Similar to the situation in Europe, states, cities and municipalities in the United States face huge budget deficits with only spending cuts or tax increases with which to fight them** – just like in Europe, states and municipalities cannot mobilize monetary policy on their own, so raising taxes (an anathema to cash-strapped residents) or cutting spending (the only real solution) are all these entities can do. With unemployment high, budgetary levels of employment and expenditures of past years are no longer applicable as sales tax revenues are lower and debt levels are high. Municipal defaults are the next big threat to the US, and only through extreme cost cutting and politicians making the hard decisions are some places going to survive the budget quandaries they have caused.

5) **Government statistics are manipulated to the point that they may give misleading information to policymakers** – the two most egregious examples of misleading government statistics are the unemployment numbers and the consumer price index. The "official U-3" unemployment rate ignores workers "marginally attached to the labor force, discouraged workers" and people "working part-time for economic

purposes", all of which to us are people unemployed who would be working full-time if they could find a job. Interestingly, the government still compiles a more complete statistic of unemployment (dubbed the U-6 Alternative Measure of Labor Underutilization) which shows a (seasonally adjusted) unemployment rate of 16.8%, not the 9.5% used by the government and media. We believe that such a high "real" unemployment rate should galvanize the government to spend the majority of their time trying to stimulate job creation, but unfortunately that is not what is happening. Secondly, the Consumer Price Index (CPI) uses some strange statistics and methodologies to "measure" prices changes; three things we think are intellectually incorrect are: 1) hedonics, 2) substitution and 3) owner-imputed rent. The CPI prices are adjusted using hedonic adjustments which means when a product is improved, the actual price is adjusted to reflect the improvements, even though the actual price may have moved much differently than this adjustment; an example: if Intel introduces a chip that is 25% faster than their last microprocessor, and sell it for 20% more, the Bureau of Labor Statistics (BLS) will "adjust" the price by the 25% "improvement" and say that the price of Intel microprocessors went down approximately 5% (due to improved performance) even though the actual price rose 20%! Secondly, in the last 20 years, the BLS has adopted substitution into its methodology, which is usually described as "when steak gets too expensive, the consumer will substitute pork instead". So, essentially, the BLS takes the least expensive meat in this example, and only measures the price increase to the least expensive substitute. Again, this sounds like it is understating real inflation because it does not do the essential job of price indexing – measuring the change in price of an object over time. Finally, instead of using changes in actual housing prices, the BLS uses changes in what it calls "owner-imputed rent", which is the change in imputed rent that the owner of a house would pay if he didn't own the house. What kind of nonsense is that? We believe the BLS is trying to combine renters and owners of residential real estate with this statistic, but again it has served to understate inflation. Finally, the Producer Price Index (PPI) and CPI are often quoted without their food and energy components because these are considered "too volatile" and that prices without food and energy better measures "core" inflation. This is really a way to further emphasize wage inflation (or lack thereof) in inflation statistics, which has again proven to dampen measures of inflation. Why? First, governments index payments such as social security payments to CPI, so the lower the CPI, the lower any increase in payments will have to be paid out year-to-year. Second, inflation expectations can get out of hand, potentially destabilizing economic behavior, so the lower the government can keep inflation measures, the less the economy will start to try to protect itself against rising future inflation. While not explicitly stated, Fed officials and government officials are constantly alluding to keeping inflation under control – this is certainly one of the ways they do this.

These problems are tough but not intractable, so what can we do to solve them?

Possible Solutions

1) **Message to the Government and the Fed: stop meddling in the economic arena and let free markets work, for better or for worse** – both the Fed and the government have applied stimulus and continue to do so; at some point, the economy must be allowed to run on its own.

Federal Reserve: The non-elected officials of the Federal Reserve set short-term interest rates; why does anyone believe this small group of non-business people (mostly academic economists, except for Betsy Duke, the only real ex-banker) can set "the right" interest rate? Solution: the markets should set short-term interest rates, just like they set long-term rates. We really should not even have a Fed, because it is owned by the commercial banks of the US but sets governmental policy, many times to the detriment of the US economy – like now, when the Fed has mandated that savers must subsidize bank profits (through too-low interest rates on short-term deposits). These are non-elected positions, but they have huge impacts on the US economy. Some will say that the Board of Governors is "non-political" but how is the Fed considered non-political if they are constantly thinking about how the Fed Funds rate might affect this or that election? The best solution is to abolish the Fed, but if that cannot be accomplished, the next best solution is to limit their powers to defined conditions for limited times.

US Government: The government needs to stop setting policy for short-term bumps in the economy that disrupt the cycle of capitalism. There are a number of examples of this: 1) "cash-for-clunkers" ended up a "success", but once the program was over, new car sales plunged to new lows and used car prices rose due to lack of supply, meaning car companies had to re-shutter capacity and less-well-off consumers that usually can only afford used cars were forced out of the marketplace completely. 2) First-time homebuyer subsidies have been used twice in the past year to get people to buy homes, but after the program ran out (and the eventual extension ran out), home sales fell to new lows. This disrupted the homebuilding industry by having to start and then stop building, and it hurt people trying to plan re-sales because it was harder to judge the market, especially trying to factor in government subsidies. 3) Stimulus bills that either: a) made government programs to spend large sums of money (usually given to political supporters' projects rather than productive infrastructure investments) or b) just gave people government money ("rebates") to spend.

2) **Reshape financial laws and regulations that make our financial system more robust but safer** – while the progression for the last couple of decades has been to have larger and larger financial institutions that provide all financial services, the complexity of financial instruments argues to us that financial firms must be either split up or compartmentalized to better gauge risk by regulators, customers and investors. Thus, we would argue that:

Reinstitute Glass-Steagall: Government-insured deposits have no business backing large trading operations, especially when interest rates are set by the Fed. While many will argue that this cheap capital is needed for counterparty risk capital, we believe that it contributes mightily to the too-big-to-fail problem. Thus, we would mandate that no trading of financial instruments occur in commercial banks with FDIC-insured deposits. Bankers/traders will scream that London / European banks will take all their business, but they will just have to live with that competition; we think that it is a false argument, and that American trading institutions compete as well as any in the world. The trading institutions, like the investment banking companies of the 1930s-1990s, would go back to the originating and trading of securities and derivatives, but would be allowed to fail if they took too much risk. Also, regulators need to be incentivized to be more vigilant and enforce the laws / rules, so that the overleverage that we saw in the 2005-2008 period doesn't cause another huge financial crisis. The current set-up (even after the new "finreg" law) almost guarantees the US will have another financial crisis, because the banks are still too-big-to-fail and managers/traders are still incentivized to take big risks.

Make all derivatives (including over-the-counter) trade on exchanges: One real problem with derivatives is they are mostly unregulated and hard to track from the outside. By requiring all standardized derivatives have to be cleared through exchanges, position limits and collateral would be much easier to track and analyze. Make it difficult to have non-standardized derivatives by having to hold large cash reserves against them.

Make mortgage loans more standardized and their origination permanently linked: the Fannie Mae/Freddie Mac debacle not only helped cause the financial meltdown, it continues today with those GSEs still guaranteeing loans with as little as 3% downpayments. The government still believes that they can help stabilized home prices by getting people with the least financial means to buy them. This is foolishness; mortgage loans should be standardized to have a minimum downpayment (unless one qualifies for a waiver through income or wealth qualifications) so that homeowners have the chance to truly afford the homes they buy. A more radical solution would be that the US changes to a model followed by many other countries (Canada, for example): make mortgage loans recourse to the borrower, so one cannot walk away from a house payment like so many are doing now. That would deter prospective buyers who aren't sure whether they have the means to support a mortgage.

3) **Cut back entitlement support programs and spending, concentrating on true pro-growth incentives** – With a bleak outlook for the future and so

many Americans receiving support from the government, it is easy to try to preserve the status quo until "things get better". Instead, the US should act to try to revive growth through structural changes, understanding that you have to experience some pain to get to the growth phase. Thus we would:

Cut tax rates or at least rollback pending tax increases: one of the main reasons small businesses aren't hiring is that they see larger tax burdens from healthcare and income about to hit them. Lowering tax rates but making more subject to tax will help restart economic growth. Unbelievably, the best example is RUSSIA! Russia went to a 13% flat tax in the 1990s, encouraging those who have cheated in the past to pay because the rate was so much lower; results? Tax receipts went up to the point that Russia almost paid back all their external debt. Building on their success, as of January 1, 2011, they will end ALL CAPITAL GAINS TAXES COMPLETELY. They expect this to generate huge new amounts of investment because people will be free to move their capital more freely, forming new businesses, hiring more people, etc. **It is a lesson the alleged ultra-capitalist United States desperately needs to learn.**

Lower corporate taxes and allow accelerated write-off of all capital expenditures: we have to try to attract capital to the US in business that has incentives to locate many other places in the world. Attracting businesses provides jobs, which then provides buyers for housing and generates sales taxes, those things which sustain US cities and neighborhoods. Lower tax rates should actually contribute larger revenues due to stimulation of business.

Establish a realistic energy policy that encourage both fossil fuel supplies as well as renewables and future energy sources: The war between government and energy businesses must be ended as the specter of peak oil and gas looms in the next few years (or sooner). By having a holistic energy policy that encourages supply of all energy sources, the US can balance its "energy portfolio" while higher petroleum costs push the marketplace to develop cost-efficient renewable energy sources. Partisan politics and eco-warfare will only eventually get us to a place with sky-high oil and gas prices and no realistic large-scale replacements – it will end up being energy suicide for the US to continue its current anti-petroleum actions and vitriol.

4) **We think Keynesian deficit spending has been proven to only "work" in the short run; governments must reduce wasteful spending in spite of the slowdown it almost certainly will cause** – One big question that we hear thrown about occasionally but never answered is this: Why do government officials think that you can solve a debt-driven recession by going into more debt? The travails of California are the perfect crucible – it seems like they go through excruciating budgetary exercises each year that are only "solved"

through temporary measures, borrowing, or accounting "sleight-of-hand", then they have to go through a worse episode again the next year. Unfortunately, the answer is to cut spending – there are no alternatives, because economic growth can help solve the budgetary problem, but not when it is already being weighed down with transfer payments, debt-servicing interest costs and growing pension shortfalls.

5) **Get ready for inflation; the Fed's policies always cause it** – It is not a good solution, but the easiest way for authorities to "grow" the country out of its deficit hole is to inflate the currency to be able to pay off debts with larger and larger amounts of dollars. This is akin to slow motion stealing from savers, who already are getting no interest, because inflation will mean that our capital buys less and less each year. However, it is the most expedient method politically, and Ben Bernanke is the consummate inflationist (as was Greenspan), **so the Fed is going to do it, and we are trying to protect your assets and capital from this unavoidable eventuality**. At some point, our foreign creditors could see their investment in our bonds to be threatened by inevitable dollar devaluation, and they will either no longer buy more Treasuries or sell those in their portfolio, which would be catastrophic for the dollar, sending it plunging and interest rates rising (to the point where they can attract capital – think Greece recently when their long-term bonds went from 5% to 12% in a few weeks). **It could happen here.**

One way to avoid this, of course, is to go back to some kind of gold standard; the banks / government / Federal Reserve don't like a gold standard because it "ties their hands" as far as money creation is concerned. However, hasn't the excessive money creation of the past couple of decades (or even few decades) proven that central banks and/or governments need the discipline of a gold standard? It is still a long way off, but having some kind of standard would inhibit the unfettered growth in debt we have seen over the last few decades.

6) **Try to rein-in our short-term mentality** – One of the things that has hurt American business over the last few decades is management's concentration on quarterly results and stock prices that then lead to great riches for them. A solution is to make their compensation consist of cash bonuses only (if they want stock in the company, they can buy some) that vests over a number of years. As the company does well and produces cash, they get paid. If it has trouble or fails, their payment is not made. It would lead to greater stewardship and concern that one's successor was competent and would make sure the company did well enough to pay off the former management.

7) **Revitalize our schools** – Like mentioned at the top, rededicate our society to educating our kids and having parents be part of the solution, because otherwise the American lifestyle will continue the slide it has started on since

2000. We need well-educated kids, with incentives for attracting those who are good in math and sciences especially. This should pay off handsomely in the future, especially because of this: the Economic Cycle Research Institute has put out some thoughts recently on the dichotomy of job losses and new job availability over the last couple of years. I thought that this (unfortunately anonymous) post of Fleckenstein Capital's financial blog was particularly on-target:

> *"ECRI has done a good bit of analysis on this, and the recent "Great Recession" involved some very interesting labor market dynamics. For those in* ***industries at the heart of the bubble (mortgage finance, construction, etc), they help make up the long term unemployed [Emphasis mine – KS]*** *that has been widely reported. In addition, the areas in secular decline due to global labor arbitrage, such as manufacturing, also fall into the long term unemployed. These labor pool segments do not have skill sets that are easily transferred into other areas.*
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> *"....* ***The little reported/known story about the "Great Recession" is that it was the shallowest on record for the short term unemployed. This is because there are legitimate SHORTAGES in many areas of the labor markets. This is all just another byproduct of the [last few years'] mis-allocation of capital ….. We simply do not have enough capable people to fill the job openings in many areas. This is resulting in shortages, as well as the inevitable wage inflation that results [from these labor shortages]. Examples of these areas are in white collar service jobs like nursing, physicians, engineers etc. [Emphasis mine – KS]***
>
> *"The result of this bifurcated fundamental backdrop is that we have massive deflation/depression unfolding in certain segments, while inflationary/booms unfolding in others. The entire transition mechanism of price has been screwed up with all of the government intervention, whether it is via bailouts, subsidized mortgage rates, student loans (get that anthropology degree for $150k to work at Starbucks!) etc. The free markets are not being allowed to restructure via incentives, both of the negative and positive variety."*

Better planning on education, and getting business and educational providers (colleges, schools, employment industry, or all of the above) to work more closely hopefully can produce a bumper crop of more well-educated, well-trained American workers like we have had in the past.

This blueprint is meant to generate ideas and discussion about what must be done to revitalize American business and society. There is enough that is "going right" that it is easy to dismiss the need for action. But we must act, through election and capital allocation, to move towards the more classical American business environment. If we do not, our snowballing debt and our way of life will be threatened, and everyone will feel it.

The Managers of Kanos Capital Management

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