September 2010 Investor Letter

Third Quarter Market Conditions

Wow! What a quarter it was – just when you thought it couldn't get more schizophrenic. July started out setting new post-recovery lows, rest of July and early August saw a rally, late August saw a sell-off that set a dark mood on Wall Street, which led to the best September in 70 years, with US stock markets gaining more than 11% and pushing performance to the positive for the year.

To recap, financial markets had ended the second quarter on a very weak note, with investors and traders still worried about world growth and the fiscal situations in European countries and the US. As July dawned, markets continued dropping as this concern continued to build which was accompanied by angst over second quarter corporate earnings to be released in July and August.

Market participants sold through the Fourth of July, but afterwards the equity markets turned around, and rallied in a nearly month-long climb to highs above those reached in June, signaling to many traders a new bullish advance attributed to corporate earnings with traders reassured that corporate balance sheets were healthy and sales were for the most part still growing. For the most part, second quarter earnings reports were considered bullish and were considered the catalyst for higher stock prices, along with some economic reports that were "not worse" (US / Europe) or showed renewed growth (China, Australia, Canada, Korea, etc.). Companies with more business-oriented customers tended to do better than consumer-oriented companies. Commodities bottomed and started to rise mid-month, and energy prices advanced as growth concerns lessened (illustrated by transport/airline stocks doing particularly well); however, energy equities participated in a more muted fashion. The precious metals, having served as a haven during economic and euro uncertainty, suffered as assets were allocated to stocks (for those in the bullish/growth camp) or bonds (for those in the deflation camp). Precious metals equities did especially poorly as European economic concerns subsided (temporarily) and thoughts of continued, if tepid, growth made more traders shed gold investments for more growth-oriented stock investments. The Federal Reserve (Fed) continued its rhetoric on starting to exit its accommodative monetary stance, and this also hurt precious metals prices.

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August continued July's trends, with the stock market indices in the US breaking out of their summer trading ranges and industrial companies benefitting the most. However, rising jobless claims, another poor jobs report, indicators of slowing growth and government-imposed credit restrictions in China led to the re-emergence of growth concerns and deflation fears. The mid-month Fed meeting produced a "sea change" for how the Fed will conduct monetary policy in the future: it changed from targeting interest rates (currently near 0% anyway) to targeting the size of its balance sheet, keeping it constant at $2.05 trillion, and stating that they will re-invest the proceeds from their mortgage-back security portfolio into longer-term (2 yr to 30 yr) Treasuries. This produced a major market sell-off as traders and investors worried about the US economy. This change in Fed operations might be the first episode of "Quantitative Easing 2" which could hurt the dollar because it should lower medium-to-long term Treasury rates, making US government bonds less attractive to yield-oriented investors. Energy sold off on these same growth concerns, dropping from $82/bbl to $76/bbl in three days. Precious metals, however, rose as the metals markets interpreted the situation as showing growing disinflationary (deflationary?) forces that would force the Fed to be even easier.

September brought a fast start, with US stock markets rising strongly each day before the Labor Day holiday, and continuing the strength. "Better than expected" was the theme of the month, as the August unemployment report came in with fewer jobs lost than expected, housing sales was slightly stronger than expected and durable goods sales were at the high end of expectations, although jobs were lost and durable goods orders dropped slightly. But the September rally most benefitted from the Fed's mid-month announcement that it found inflation levels lower than what the Fed judged to be "consistent with its mandate for maximum employment and price stability". The financial markets within the hour judged that this would mean more inflation (<u>promoted</u> by the Fed), which was judged good for most asset classes [including bonds!]. Thus, the stock market saw its best September gain in 70 years, bonds stayed strong and commodities rallied, with precious metals hitting new highs. Industrial stocks benefitted the most from the rally as emerging markets were judged to be strong enough to keep the world [despite US and Eurozone economic lethargy] economy growing.

Precious Metals

Gold had hit an all-time high at the end of June, but mid-July financial market shifts toward recovery themes knocked down precious metals prices during the month, affecting precious metals mining shares more acutely. Re-emergence of fears of deflation and economic malaise starting in late July led to a recovery in precious metals prices that were buoyed by the Fed's announcements in the August and September meetings, indicating increased debt monetization in the future and leading to even higher precious metals prices.

While following metals prices, precious metals mining shares underperformed the metals themselves as investors continued a "show me" attitude for financial results from large mining companies. Many miners, most notably Newmont Mining, has had disappointing earnings reports in the past, although its 2Q2010 report showed growing profitability. We believe the market will value mining company shares higher in the future as companies prove their operations, show increasing profitability and don't issue large amounts of new shares (large issuances have happened in the recent past). We also believe that as more traders and investors buy into gold's bull market, more will be attracted to the leveraged returns of gold miners (miners benefit as metals prices climb because much of their cost to mine is fixed or mostly fixed – thus price gains fall to the bottom line). We also believe that more mergers and acquisitions will happen as larger miners start to find less dilutive acquisitions of smaller companies with undeveloped mining prospects – we hope to own the acquirees and believe our position in the acquirers will benefit from low-cost development projects.

Energy

Oil prices fluctuated between the low $80s/bbl and the low $70s/bbl as crude oil prices followed equity markets but boosted at times by a weak dollar. Petroleum stockpiles in the US remained at multi-year highs, but crude supplies did not overwhelm refiners and steady use of petroleum products kept both gasoline and distillate prices near $2.00/gal wholesale. This range-bound trading made energy the laggard in the third quarter – stocks, bonds and most other commodities gained during the quarter, while crude managed only a small gain. The worst performing commodity was again natural gas, which had been buoyed during June by extreme heat in US population centers and expectations of an active hurricane season. The third quarter saw moderation of temperatures, especially on the East Coast, and an active storm season where most of the storms either hit Bermuda or Mexico, sparing the US almost completely.

Energy stocks therefore had a pretty poor quarter. Our oil sands stocks were less-than-stellar performers as operational upsets led to reduced production during the quarter, lead to almost quarter-long weakness in our Syncrude positions (Canadian Oil Sands and Suncor). Oil-oriented stocks gained during the quarter, but most natural gas stocks (which we mostly avoided) did very poorly. Oil services stocks, while surviving the Gulf of Mexico drilling ban admirably, also underperformed as investors rotated investments to "hotter" stock market sectors like technology and beaten-down industrial companies.

General Stock Market

As mentioned above, the US stock market fell hard in early July and again in late August, but rebounded each time, especially in September with surprisingly sharp (nearly 9%) gains. Much of these gains were led by past leaders in technology (Apple, Google, Salesforce.com, cloud computing companies, etc.) but airlines (+24%), retailers (+20%), consumer durables and industrials (+19%) also had large gains late in the quarter as the Fed's easy money policy was judged good for the economy. Economic statistics have not shown much strength, so the stock market continues to be ahead of the economy, making most stocks look expensive.

Financials, housing and more "nuts and bolts" technology firms (like chip companies and hardware makers) joined the energy sector as laggards during the quarter. Financials did not show any real pickup in earnings from trading (as had happened in quarters past) and suffered as foreclosures mounted and legal questions surrounding title to foreclosures threatened to slow down disposing of foreclosed real estate. Housing continued its extreme weakness with near historic lows in housing starts and weak existing home sales hurting homebuilder and housing stocks. Slowdowns in worldwide demand for chips and hardware hurt some technology subsectors, reinforcing economic slowdown fears.

Other Markets

The real story of the third quarter, especially in July and September was the downward move in the US dollar. Weakness in expectations for future economic growth knocked the dollar down during July, as both monetary and fiscal policy seemed to be ready to be tightened while the recovery was still only weakly proceeding. The Fed's targeting of maintaining its balance sheet buoyed the dollar in mid-August, but pessimism about the efficacy of this "monetary medicine" led to a resumption of downward motion in prices, which was fueled by the Fed's September announcement foreshadowing "QE2" easing in the future, leading to large numbers of new dollars to be created.

The bond market, perversely, rallied for much of the quarter, as the concerns about too many dollars were trumped by the thought that the Fed would be bidding for Treasuries and make profits for holders. Thus, all maturities of US Treasuries rallied, with the 2-year and 30-year rallying strongly (the 2-year reached new all time highs in price, lows in yield at 0.4%). The rally in Treasuries led to near historic lows in other fixed income markets, including mortgage rates (less than 4.5% for a conforming 30 year mortgage) and corporates. Notably, IBM issued 3-year notes for 1%, and later in September Microsoft issued 3-years for 0.875% and 30-years for 4.5%. The reach for yield by pension funds and those in need of investment-generated yield continued to snap up corporates and municipals, leading to historic low yields and high prices for bonds.

Investing Going Forward

We've devoted our Commentary below to revisit our current investment thesis, so it appears in place of this section.

Kanos Quarterly Commentary

Our Current Investment Thesis

I have been a "bottom up" investor all of my career, i.e. I have looked at individual stocks and picked investments by the attractiveness of the fundamentals surrounding the company, the financial ratios, the technical situation of the stock, etc., always keeping an eye on what is happening in the markets and US economy as a whole.

However, in recent years, and especially in the past three years, I have found that I needed to start looking at the economies around the world, and the US economy in particular, to try to form an opinion about economic activity in various regions before evaluating current and future investments. Increasingly, governmental activity (or interference) along with central bank actions, have played a larger role in helping us determine the investment climate and how we wanted to deploy our investors' capital.

Three Things to Watch These Days

Since governmental and central bank activities have become such a large day-to-day factor in the financial markets, we have tried to distill the best way to frame the factors that affect our investments, and we use the following framework:

1) Analysis of economic activity, both domestic and worldwide;

2) Analysis of governmental policies and future legislation/regulation, coupled with central bank's policies and signals for future policy;

3) Determination of sectors that would benefit (or those that would be at a disadvantage), then an examination of these sectors for attractive investment candidates (or possible short sale candidates).

While this framework may seem obvious to some investors, we have found that while we have been following this framework for the past few years, that we had not formalized it. It has evolved naturally and has forced us to concentrate more than in the past on economic factors. As investors first and economists second, we believe our approach to economics is from a different perspective than many of those analyzing the economy. My economics background was a general economics class as an undergraduate and two classes in graduate business school, but my most influential class, Macroeconomics, was taught by a market watcher, Jeremy Siegel, who approached it from a financial markets perspective. We too have approached economics from the markets' perspective, which has allowed us to see the economy differently than most Wall Street economists, thus freeing our investments to be more contrary to mainstream thinking. We think this serves our investors well, as we constantly question whether things in the “economic realm” are necessary or even effective (e.g. stimulus, monetary policy, etc).

We would like to use this commentary as a forum to re-iterate our current investment thesis and our reason for concentrating our investments in natural resources, specifically precious metals and energy.

Background

To understand our current investment climate, I want to summarize on how we have gotten to this point.

The 1970s economic boom from natural resources and the resulting 1980s bust in developing countries led to a number of them reengineering their economies to embrace capitalist economics and the export success of Japan during the 1980s. The developing world, especially in East Asia, combined large populations in close proximity to natural resources which provided a low cost engine for economic growth in the 1990s and 2000s. A number of countries adopted the export/mercantilist model of Japan: Korea, Hong Kong, Singapore and Taiwan, followed by China and India, which were quickly followed by Thailand, Malaysia, Vietnam, the Philippines, and others, finally followed by Russia and its former satellite states. China, Russia, Vietnam and other communist countries had replaced their failed centrally-planned economies with grass roots capitalism, providing low cost goods and services due to the following feedback loop: more workers -> more competition -> lower wages than developed world -> low but rising productivity -> expanding wealth for workers -> more workers…

The developed world was able not only to maintain but raise standards of living due to new technologies and resultant productivity gains, meaning efficiency (coupled with low costs of materials) offset rising wages and benefits costs. Innovation from many different quarters, including the Space Program and the Department of Defense (from Cold War innovation) bloomed in the 1980s / 1990s / 2000s, drastically improving productivity and leading to higher developed world lifestyles.

Relative peace worldwide, combined with rising standards of living, stable governments and spreading democratization (Russia and Eastern Europe, looser governmental controls in China and much of the Middle East) led to increased political stability, which allowed for more stable financial systems, allowing increased borrowing as interest rates continued to fall due to lower political risk and inflation.

Inflation was contained during the later 1980s and 1990s as natural resource surpluses built up during the 1970s and early 1980s were exploited (at low cost) and higher productivity worldwide contained price rises. Examples of surpluses included US domestic natural gas, which sold for between $1.00 and $3.00/mcf for much of the later

1980s and early 1990s, and copper, which sold for between $0.30 and 0.70/lb during that time.

After the end of the 1982 recession, the US had only one recession for 18 years (the 1990-92 recession caused by US banks' Latin American debt defaults, US savings and loans failures and the resultant real estate bust, and the defense cuts due to the collapse of the Soviet Union), meaning many sectors were able to grow and prosper for 15+ years. Recessions generally wash out the underfunded, overextended and "sense-less" businesses that occur during booms. The confluence of major innovations, cheap capital (especially in the form of low-interest rate debt), large amounts of cheap labor and stable governments worldwide led to the huge business booms of the 1990s worldwide.

The Federal Reserve and Its "Too Low" Interest Rates

The abovementioned business boom eventually overheated and caused a number of crises, starting with the Asian Crisis of 1997 where Thailand, Malaysia and a number of other countries and markets experienced overbuilding and bad investments which led to business and bank failures. The Russian debt crisis of 1998 which helped cause the collapse of Long-Term Capital Management [the biggest hedge fund in the world] further destabilized world financial markets. The US Federal Reserve reacted to these events by providing more liquidity and lowering interest rates, which led to an overheating of the US economy and culminated in the dot-com bubble, where concepts with questionable business viability were financed and investment euphoria reigned for almost two years. The crash of the dot-com bubble and the resulting decline in stock prices foreshadowed the mild recession in the US economy starting in 2001.

But rather than have a "normal" recession that would kill off bad businesses and provide capital for better and newer businesses, the Fed slashed interest rates to near historical lows (1% Fed Funds rate), which caused a number of distortions: 1) while the dot-coms that were "sense-less" were killed off, weaker businesses stayed alive using historically low short-term interest rates to finance themselves, 2) low interest rates allowed many "low-growth" businesses to expand, keeping employment high (this was the "low unemployment recession" of 2000-2002), and 3) low interest rates allowed individuals to maintain or raise their standard of living through increased borrowing, most notably in residential real estate (aka "the housing bubble").

While the recession was deemed to have ended in 2002, short-term interest rates were kept low by the Fed for more than a year afterwards, and financial firms (hedge funds, banks and leveraged private equity) took most advantage, leveraging themselves to greater multiples than had been seen since the 1920s, allowing huge returns with only small amounts of equity in investments.

With interest rates low, savers and investors who relied on investment income to live were forced to invest in riskier assets than they had in the past, since higher yielding municipal and corporate bonds were called after being refinanced at lower levels. This led to more investors buying mortgage-backed securities (MBS) and other asset-backed bonds, which continued to provide higher yields than comparable maturity corporates, governments or municipals, and were rated highly by ratings agencies because underlying housing prices were strong and still rising.

Eventually, leverage ratios peaked as asset prices rose to historic highs – housing peaked in 2007, the Dow Jones Industrial Average hit its all-time high in October 2007 and leverage ratios of banks and investment banks hits their highs in early 2008. Housing prices, which had risen for a number of years and allowed owners to leverage their houses more and more, began to fall steadily, as overleveraged homeowners could not pay their mortgages and supply of housing caught up and passed demand. This peak and subsequent decline in housing prices undermined the mortgage investments that depended on mortgage payments and high housing prices. Worldwide, banking institutions had borrowed money to support large amounts of mortgage bonds and MBSs, and by 2008, the mortgage securities were falling in value. More thinly capitalized investment banks, Bear Stearns, Lehman Brothers and Merrill Lynch, either failed or were taken over at very low valuations. AIG, which had insured the value of many mortgage bonds, would have failed but was rescued by the US Government and the Fed. Bank balance sheets got closer to insolvency during the fall of 2008, and government guarantees of bank deposits (up to $250,000), money-market funds and bank-issued bonds were combined with the government's TARP injections of liquidity and barely saved the US financial system. Stress tests, performed in early 2009, allowed investors to gauge the financial health of US banks, and most large US financial institutions raised enough private capital to pay back TARP loans and carry on business, albeit supported by a very steep yield curve arranged by the Fed, where banks could borrow from the Fed at near 0% rates in the short-term and lend risk-free to the US Government by buying AAA-rated Treasury bonds of longer duration. This Fed-engineered interest-rate-spread trade has allowed banks to eschew private lending and earn large risk-free profits for almost two years.

But now the US economy has reached a crossroads: the economic bounce-back from the shock of the 2007-2009 recession has plateaued, as inventories have mostly been rebuilt but hiring for expansion has not occurred in any large scale. Interest rates are low, but banks are not lending to high-risk clients and cash-rich large corporations are holding large amounts of liquid capital, unsure of the regulatory and tax regimes that have gotten more onerous under the Democrat-controlled US government.

Factors Impacting The Investment Environment

Anticipating the November election results [we put off publication until they happened, and sure enough, the Republicans won a large number of House and Senate seats and governorships, and taking back control of the House of Representatives], the financial markets had predicted that there would not be more fiscal stimulus coming from

Washington in the near future as the politicians would be under pressure to rein-in spending from levels of recent years. The voters have expressed their views through their choice of elected officials, and the popular thinking is now that deficits are unsustainable and that debts are too high and must be stabilized if not reduced in the future.

Thus, the Fed sees itself as the sole source of future economic stimulus for the United States. After the Fed's first bout of quantitative easing, starting in March 2009, the economy and financial markets improved dramatically, and the Fed believes that it should re-use this "recipe". **[On November 3rd, the day after the election, the Federal Reserve announced that it would buy medium-dated Treasury bonds at a $75 billion/month rate, for eight months, and re-invest the maturing proceeds of their mortgage portfolio in Treasuries, resulting in a $900 billion program of quantitative easing or "QE2".]** There are a number of reasons why they decided to use QE2 for their latest policy tool:

1. The Fed currently has short-term interest rates at zero, thus the Fed is "pushing on a string" to try to encourage lending growth because big banks are leaving large amounts of reserves sitting on Fed's balance sheet, earning interest and keeping the money there to retain liquidity as a buffer against future losses. These large banks don't want to extend more risky borrowing (their balance sheets are still full of risky mortgage, corporate and LBO loans), and instead the banks are using the Fed-engineered "carry trade" (borrowing short-term at near 0% rates and buying longer-term Treasuries to make the interest rate spread and build back their weakened balance sheets.
2. Without any growth in lending in the US economy, the Fed does not see much growth in economy; the majority of post-2008 growth has been rebuilding inventories, not increased final demand. Consumers have been using disposable income to pay off debt and buy mostly essentials instead of buying durables and discretionary items whose sale has powered the economy over the past two decades.
3. The Fed wants to generate demand ("get economy going") and to do so needs to get money out into the economy and circulating, so it has openly signaled QE2 (starting in late summer) to try to get longer-term interest rates lower. The Fed also feels QE2 will put more dollars out in the world economy, which means lower US dollar purchasing power going forward. The Fed believes more and lower priced dollars will generate inflation, which will then stimulate demand (as people buy to protect their wealth's purchasing power).
4. More dollars means a lower US dollar versus other currencies (and hard assets, most notably precious metals and other commodities). This will also make US exports cheaper around the world, further stimulating the US economy by growing production of goods and demand overseas for cheaper US goods.
5. The Fed does not see the danger of a lower dollar (possible "wholesale" flight out of dollar assets) or inflation (Fed has generated inflation over its history, thinks it has helped stabilize US economy). We think they are wrong – inflation pulls demand forward, ravages older savers (who generally earn fixed incomes and can't keep up with higher prices) and the middle class (living on current salaries and low savings rate).

Inflation does help out the indebted, which include many owners of lower-end housing as well as the US government, because debts get paid back in "lower priced" dollars.

Thus, the Fed has decided to fight what it considers strong deflationary forces in the economy by trying with larger and larger tools to generate inflation, and from inflation, higher future demand for goods and services.

But what are exerting deflationary forces in the US economy?

1) Residential real estate prices are still dropping or pausing in their descent – this is deflationary because would-be buyers feel incentivized to wait for lower prices in the future. But there is surplus of homes built during the 2000s boom, and the surplus will be slow to work off because…..
2) Job losses during 2007-the present have been large and slow to reverse. This again is deflationary, as job seekers in many cases are willing to work for less (or even temporarily for no pay) in order to find permanent or semi-permanent work. Since there are millions out of work, many consumers are having a harder time servicing their debts, so…..
3) Consumer balance sheets – many consumers have mortgage or credit card debt that is being paid down; this is deflationary as cash is used to payoff debt instead of buying new things. But with large numbers of workers with no current job, when jobs are secured, they tend to try to shore up their finances so they will be able to withstand any future downturn.
4) Financial institution balance sheets – Banks are shrinking their balance sheets voluntarily (not extending loans coming due) and involuntarily (as risky loans default, are written down or are worked out); again, shrinking balance sheets are deflationary, because cash is used up to retire loans and new credit is not extended to finance new growth in the economy.
5) Corporate balance sheets – from their scare of 2008 when credit disappeared for even some good corporate credits, corporations are holding more cash on their balance sheets to protect against possible future liquidity needs. Meanwhile, they are not hiring at typical recovery levels because they are unsure of need for more employees in near future, and they are not buying companies as acquisitions are generally not yet attractively priced. This is disinflationary, as cash sits on balance sheets and is not spent or used for investment.
6) Corporate private investment – companies have been reticent to spend as increased taxes, more government regulations and an uncertain economic environment discourages new investment; this is slightly disinflationary, meaning it could be used to invest, but is just sitting currently on deposit.

This is the situation the Fed sees – financial, corporate and personal balance sheets shrinking as debts are retired and new credit is rare. Thus, real economic growth is anemic, as GDP is from trade and inventory building.

But the factors that the Fed does not focus on or care about are important, in our eyes:

1) Money and loans are historically cheap as interest rates are historically low (for borrowers who can qualify for loans, which is still a large number of people) – this factor is historically very stimulative, and in an economy that is self sustaining, it should be quite inflationary.
2) The world economy is in a general growth trend, ex-the US, Japan and Europe. Thus, while our government and central bank (and Japan's) have been stimulating the US economy (as have the Europeans but to a lesser extent, especially during 2010), the rest of the world is using raw materials, labor, capital and lending to grow their economies and build out their infrastructures. Thus, this worldwide real end-use is inflationary, driving up the cost of raw materials, which impacts all economies; for example, copper is up 26% year-to-date.
3) Growing world population and increased usage of grains as fuel have put pressure on world food supplies. While bountiful harvests in the recent past have allowed the world to eat cheaply, weather interruptions (especially droughts in the former Soviet Union and China) have caused food prices to rise sharply, increasing the cost of food around the world. For example, year-to-date through September 2010, some prices are up substantially, like sugar +47%, wheat +40% and milk +23%. This is inflationary, as rising food costs start to put pressure on governments to help stem the rise or subsidize costs, which is an additional inflationary driver.
4) Crude oil prices have stayed stubbornly high, meaning the cost of transportation and to a lesser extent, manufacturing and heating costs, are high on a historical basis. Energy price gains year-to-date include crude oil +6%, heating oil +12% and gasoline +0.5%. While plentiful natural gas has alleviated this situation for home heating in some regions and some manufacturing in others, energy costs have contributed to rising raw material prices, which is inflationary.

The Fed has generally minimized the importance of rising raw material costs, especially that caused by higher food and energy costs, because those prices have historically been very volatile, and many times in the past they have fallen quickly after large price rises. The Fed and traditional economists are really mostly concerned with "demand-pull" inflation in the form of higher wages and higher economic activity; since the Fed sees the opposite, it is "not concerned" about inflation, and is **actively trying to raise inflation to "its mandated levels", defined as 2% annual inflation or so.** While demand-pull inflation seems to be dormant, we believe it is "just below the surface" in the US economy, as illustrated in more inflationary factors below:

1) Higher raw material costs have been blamed in the last couple of months by consumer products companies in their earnings releases for lower profits.

They say that higher food, fuel and raw materials used in packaging and manufacturing have caused lower profits. Thus, many companies are on the verge of raising prices or lowering portions while keeping prices fixed (the "smaller cereal box" phenomenon). This is obviously inflationary. Examples include: General Mills (which sees 4-5% cost inflation from grains), Kimberly-Clark (margin pressure from stubbornly high paper costs and weak consumer demand precluding price increases) and Dean Foods (gross profit declined 4.6% due to higher dairy costs). In fact, the *Wall Street Journal* had an article on October 2, 2010 titled "Gingerly, Retailers Try to Pass Along Higher Costs" which references companies like Philips-Van Heusen (clothing) and Anheuser-Busch, both of which are raising prices but experiencing falling margins due to even higher increases in raw material costs.

2) While the Fed is not concentrating on traditional inflationary price increases, these costs continue to go up: a) health care costs have continued to go higher, skyrocketing in many cases due to the new Obamacare framework. Personally, our health insurance premiums increased for next year 18.2%, and we instead opted for an even higher-deductible plan to minimize the increase, but still ended up paying more than 10% higher premiums. Anecdotal evidence abounds in which companies' healthcare increases range between 10-20% higher this year alone, after many years of increasing costs, and b) private education costs have continued their high single-digit increases, with college tuition increases averaging 8-9% higher for 2009 (latest date for figures).

3) Wages are actually rising, although we don't see much of that in the US, Japan and Europe. Wage rates in India, Korea, Thailand, Malaysia, Vietnam and the Philippines, after being low for many years, have stabilized and in some cases have started to rise as inflation (from increased world money supply) has caused higher food, fuel and raw materials prices in these countries, leading to workers' demanding higher wages. In China, there have been riots and production stoppages as workers have struck for higher wages. Even in the US, public sector unions have started the drumbeat for rank-and-file members to receive cost of living wage increases, even in the face of job cutbacks and shrinking state and local government payrolls.

Thus, in spite of non-developed world demand-pull inflation, coupled with higher raw material, energy and food prices, the Fed does not see enough inflation and is actively trying to generate more. **We believe they will succeed beyond their wildest dreams, leading to a repeat of the 1970s experience (and possibly even worse), in spite of moribund economic growth and continued weakness in US job markets.** A weaker dollar will certainly help nominal growth in the US, but it will do so by destroying the purchasing power of large segments of the US populace.

Investing in a "Building Inflation" Environment

Generally, with the Fed pursuing strong inflationary programs, we must think about how to take advantage of the investment environment to preserve wealth and purchasing power.

Commodities have traditionally been the best store of value against depreciating currencies and inflation. Some are more economically sensitive (energy, industrial metals, etc.) and are thus more volatile in uncertain economic times, while others, like soft commodities (foodstuffs, grains) and precious metals (gold, silver) are better stores of value over time. Commodities can take the form of physical (like gold bars or food supplies), exchange traded funds or futures contracts. For longer-term investments, we have found that commodity-based equity investments are attractive candidates as long as target companies combine appealing supply/demand fundamentals with US dollar cost advantages; successful companies have generated growing profits which have led to higher stock prices over time.

Bonds would appear to be the investment that would suffer the most over time – more US dollars in circulation would mean fixed income received over time would hold less and less of its purchasing power, and in addition, rising rates (demanded by bond investors as inflation builds) would erode the principal value of the bond. Many deflationists see the opposite, and have made money over the past many months as long-dated Treasuries rose (supported constantly by Fed purchases). Except to sell to the Fed in QE2, bonds to us seem like a losing investment (and holding bonds to sell to the Fed under QE2 seems very risky to us).

Cash is a good way station for capital, but just like the bond argument above, cash will gradually lose its purchasing power over time, and cash investments essentially pay no interest currently. We believe at this time we should de-emphasize cash except as a short-term "warehouse" until attractive opportunities arrive (like in an equity market downdraft).

Equities are decent candidates for investment in an inflationary environment **<u>IF AND ONLY IF</u>** companies can pass-through all of their cost increases (wages and/or raw materials) when needed. Thus, with fewer fixed components than bonds, equities [especially foreign equities] appear to be another investment that has the elements to protect your wealth against inflation.

However, will all types of equities protect us? We have put together a thumbnail evaluation of US equity sectors represented in the S&P 500 to give some reasons for our enthusiasm for holding or reasons for avoiding equity sectors:

<u>Energy</u> – Oil is the lifeblood of world economies and world trade. Natural gas is a primary source of energy for heating and chemical feedstocks. Coal powers much of

the world's electricity generation and also is cornerstone heat source for much of the world. We believe that oil is more supply-constrained and subject to much higher prices as developing world (esp. Asian) economies continue growing, causing demand to outstrip ready supplies. Coal (for environmental reasons) and natural gas / liquefied natural gas (which have gluts of current production) are less attractive investment candidates to us presently. So we have emphasized crude oil-based investments, have limited natural gas investments to low-cost opportunities, maintained some oil service stock exposure, and only bought into coal companies at extremely low valuations.

<u>Materials</u> – Basic material for the most part should be good protectors of value, as industrial commodities and semi-finished goods (like iron and steel) maintain their world value and are thus marked-up in US dollar terms. However, we are still wary of a double-dip recession in the US economy and spooked that a recession could cause extreme US economic weakness and/or another financial crisis/banking crackup which would hurt world economic growth, putting extreme downward pressure on industrial commodities prices. So we have limited our investments in materials. We cover precious metals, on which we are very bullish, in a separate section below.

<u>Industrials</u> – Like many other industries, we are wary of margin compression in industrials as raw materials and labor prices rise with the Fed-engineered inflation and tepid end demand doesn't support price rises needed to offset higher costs. Transports are part of industrials, and while attractive fundamentally, valuations are high for transportation companies, dampening our appetite for them presently. So for the most part, we have de-emphasized investments in more economically-sensitive Industrials.

<u>Consumer Discretionary</u> – The continued deleveraging of the US consumer has made the consumer discretionary stocks trade erratically during the recovery, switching between strong advances when (good earnings are announced or good economic statistics are announced) to rapid drops (due to bad earnings or weakening economic conditions). We are still unsure of a lasting economic recovery, and with our wariness of a possible double-dip recession, have completely avoided consumer discretionary stocks.

<u>Consumer Staples</u> – In times of uncertainty, consumer staples have usually been good investments for maintaining one's capital and receiving a yield. However, the rising cost of these companies' raw materials has already started impacting their earnings, making these companies less attractive than in times past. Recent advance in stock indices have also made valuations rich for a rising inflationary environment [valuation multiples generally drop during inflationary times as investors doubt companies' ability to pass along cost increases], so we have maintained consumer

staple investments but have had less enthusiasm for adding new positions to this sector.

Health Care – The margin compression caused by recession and anticipation of Obamacare has caused most health care companies to underperform in the stock market. We have also been put off by the stubbornly high valuations in companies with otherwise attractive fundamentals. Thus we have concentrated our investments in the lower value, higher yielding pharmaceutical stocks which we believe have lower downside than many other health care stocks and pay an attractive dividend from efficient operations. The worry in drug stocks? Uncertain new product development and the attendant new drug pricing power.

Financials – We have been short financials or mostly out of financial investments due to the opaqueness of bank operations, the apparent need for continued governmental (and certainly Federal Reserve) support, poor asset quality on financial balance sheets and our fear of higher interest rates. Thus we have confined most investments to well-capitalized, less-exposed Canadian banks, although they are no longer the values they once were. We don't anticipate adding financials to portfolios until US economic strength seems to be self-sustaining.

Information Technology – While many large technology companies are highly valued for their franchises and pricing power (Apple, Google, Oracle), most technology businesses are extremely competitive and self-cannibalizing, meaning that the ability to recover costs of new products may be difficult, especially if you cannot impose pricing power to recover costs. And hardware manufacturers are subject to the same costs pressures as other manufacturers, where the cost of materials may climb faster than pricing changes. Thus, we believe that the historical bias of many investors that technology is a growth sector is not always true, and while we acknowledge that technology investments are cheaper than new employees, we believe that much of this new investment has already happened incrementally over the past two years, meaning there are fewer companies that will benefit than the market is anticipating (we believe Microsoft is an exception and will continue to benefit from Windows 7, Office and its cloud computing businesses, all in upgrade cycles).

Telecommunication Services – We are wary of AT&T and some of its brethren due to their inefficient organizations and continued loss of higher-margin wireline telephones, but we have owned some telecom companies [Verizon] for their yield and relative fundamental attractiveness.

Utilities – Utilities, while tangential to many of the energy businesses we favor, are constrained regulatorily in their ability to pass on price increases quickly, so we believe that they will suffer with lower valuations as inflation makes cost recoveries for utilities a multi-year, painful process. Thus, we will tend to shy away from utility investments, as we also believe they will be harmed by higher long-term interest rates.

The Continued Case for Precious Metals Investments

With the Fed signaling QE2 starting in August [and it becoming a reality in early November], investing in precious metals makes more and more sense. While QE2 is a strong factor in making the risk/reward equation for precious metals investing more attractive, it is not the only reason to be making these investments. Here are more:

1) Supply and demand dynamics – silver is in deficit, meaning there is more demand than current production, while other precious metals like gold and platinum have had limited net production gains due to the financial upset of 2008-2009 causing new mines to be shelved or cancelled. As an example, South Africa, traditionally the largest gold producer, has had falling production for many years and currently only produces around half of what it did at its peak in the late 1990s.
2) Central bank demand – with quiescent inflation in the 1990s and early 2000s, a number of European central banks divested a lot of their gold and invested the proceeds in income-producing bonds. Now many Asian central banks are increasing their gold holdings to balance the large amounts of assets held in depreciating currencies. Thus, what had been a source of supply (European central bank selling) has become a source of demand (Asian/Russian central bank buying). The Russian Central Bank announces its monthly gold purchases, and much like in China, Russia basically restricts export of domestically-produced gold, having the central bank buy much of the production. Small Asian central banks in Sri Lanka and Bangladesh have been buyers of IMF gold in recent months, showing even smaller countries are attracted to gold as a store of value for their monetary reserves.
3) Crowded trade? – While gold buying has seemed like a "crowded trade" to some financial market observers, it is not reality. According to Yahoo Finance, the entire Gold subsector of Basic Materials currently has a market capitalization of just over $200 billion, less than ExxonMobil or Apple and about the same size as Wal-Mart. The largest cap gold stocks have not even hit their 52-week highs as gold has set new records, so they certainly don't seem "frothy". Anecdotally, the 2010 London Bullion Market Association meeting in Berlin (held in September and which saw record attendance) surveyed participants at one point, and over 90% of participants at the conference said they had less than 5% of their personal wealth in gold – and these are gold proponents! Thus, there is still a large amount of latent demand that could move into the gold market.
4) Uncertainty – Gold and silver throughout history have been stores of value that cautious people have used as investments against uncertainty, war and monetary debasement. The recent price rises of precious metals generally

reflect heightened uncertainty – gold/silver no longer move daily in opposite directions to the US dollar; instead, uncertainty at times causes the opposite: turmoil in Europe in 2010 has caused flights to safety into BOTH precious metals and the US dollar.

Thus there are more reasons than in the past to protect one's capital with precious metals investments. We intend to over-emphasize precious metals as long as the Fed continues its easy money policies and the US Government continues to borrow large amounts. We believe both will be US dollar negative and precious metals supportive. We also anticipate a lot more monetary turmoil in Europe, causing a flight to safety into precious metals and precious metals investments.

Final Comments

Finally, there is one more theme that impacts our investments significantly: non-traditional distortions in the financial markets that make it more difficult to invest traditionally for the medium-to-long-term:

1) The day-to-day market is dominated by computer-based and high frequency traders (up to 62% of daily volume, according to CNBC), which rob large institutional investors (mutual funds, pension funds, foundations, etc.) of capital through worse trade executions, increased volatility and investor uncertainty.
2) Government and central bank "stabilization" and interference:
   - arbitrarily low interest rates – lead to misallocation of capital due to interest rates not set by free markets and overleverage in all sectors of the economy (still);
   - Fed buying long-term Treasuries in quantitative easing programs – centrally-planned economies have proven not to last (the latest failure being the Soviet Union); why then does the Fed think they can steer the economy to success by keeping long-rates low?
   - US Government fiscal stimulus programs don't create more demand, instead they "pull forward" future demand – cash-for-clunkers, homeowners credit, foreclosure forbearance all ended up having spikes in demand, but troughs after the programs lapsed. This is typical of politicians, trying to "do something" but really just distorting economics, which leads to higher initial demand followed by the "hangover" of reduced demand which has been "pulled forward";
   - Taxation policies which are subject to constant change breed maximum uncertainty – tinkering with tax policies can also lead to bad investment choices, and the risk/threat of higher future taxes will certainly lead to massed selling that will hurt asset prices in general [the recent advance in the stock markets is the general belief that the US Government will extend the "Bush tax cuts" at least for another year];

- New regulations, most notably the Obamacare health care program, coupled with economic uncertainty, have made potential employers shy away from new hires, further complicating economic recovery.

3) Large populations of momentum, trend-following and technical traders magnify moves in equity prices; when companies miss earnings estimates, routinely stocks lose more than 10% of their value, even though the real effects of the earnings disappointment may be much smaller than the fall in the stock price. Meanwhile, companies with questionable fundamental attributes can move higher daily, driven by cycles of momentum buying and short covering. While not unique to this time period, momentum investing when coupled with high frequency trading and governmental/central bank distortions, make for a difficult investing environment.

The Managers of Kanos Capital Management