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First Quarter 2024 Investor Letter

First Quarter Market Review

The market advanced once again in the first quarter, led by artificial intelligence-oriented ("AI") stocks. Late in the quarter, industrials, financials, materials, energy and retail strengthened, leading to a broadening of the latest advance in the stock market. This occurred as economic strength was maintained in the US economy, reducing the amount of expected rate cuts expected for 2024, from seven expected early in the quarter to only three after the Fed's March meeting. Bonds did not fare as well as drops in inflation moderated, and fewer expected rate cuts pressured short-term interest rates higher. The US economy's growth was led by expanded government spending as well as worldwide technology spending in the AI "arms race" of new generative AI products, similar to ChatGPT. Worldwide economic growth was led by the US again, as Chinese and Europe area growth sputtered, leading to projections of interest rate cuts by many central banks in 2024. Copious US market liquidity combined with the promise of rate hikes offset most of the angst of continued conflicts in Ukraine and Gaza and the wildcard of the approaching US election so far.

Looking Forward

Introduction

The second quarter of 2024 is turning out to be a fight between the Fed and markets, with a metaphorical "game of chicken" starting to break out. As inflation dropped in 2023, Chair Jerome Powell and the Federal Open Market Committee declared that inflation was trending the right way, and they saw easing as the next step, starting in 2024. Stock, bond and other markets around the world reacted to this news aggressively, pricing in as many as seven rate cuts in 2024/25 as inflation reports trended down. However, as 2024 progressed, inflation has stopped dropping, while GDP and nominal job growth has stayed strong. The Fed has continued to put off rate cuts, and as economic data continues to support keeping interest rates higher, the markets have priced out rate cuts, currently pricing in just 1-2 cuts in 2024. However, while headline economic statistics look strong, a closer look "under the hood" of many of these statistics shows some deterioration in the economic picture of the US, leading to markets staying in "rate cuts soon" positions, despite a drumbeat of Fed denials of even one cut in the near future. Hence, the game of chicken – markets are still pricing Fed cuts because they see economic deterioration on the horizon, while the Fed continues to resist easing. Markets are gyrating around news releases, Fed speeches, earnings announcements and economic statistics updates. So far, no resolution appears imminent.

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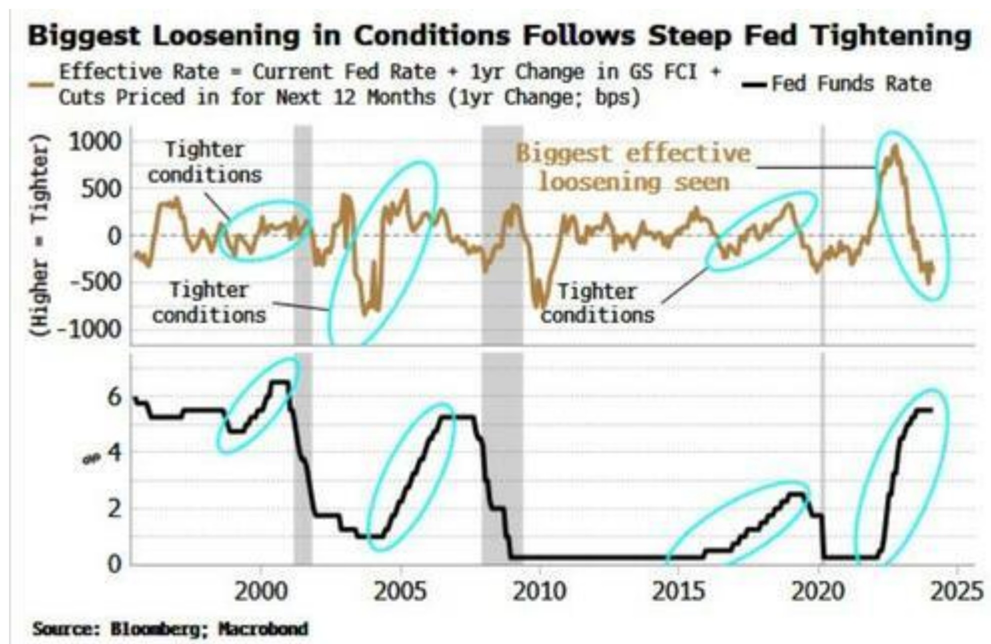
Economy

The US economy continues to grow, although at the same time, there are a number of indicators that indicate slowing. The Atlanta Fed had a real-time GDP estimation model that had US real GDP growing at a 2.1% annualized rate for 1Q 2024, but when it was reported late last week, GDP came in at only 1.6%. This is different than recent past quarters, in which the 3Q 2023 quarter saw a +4.9% annualized growth rate and 4Q 2023 was still +3.3%. The quarterly readings, except this last one, are far above the 1.5-2.0% GDP growth rates we typically saw pre-Covid. We believe there are two main reasons for this growth: financial conditions and government spending/reshoring/friend-shoring.

Financial Conditions: Continued high interest rates should have slowed economic activity over the past couple of years, which the Fed was trying to do as the economy ran hot with large Covid-lockdown stimulus and accommodative Fed policy and action. The large amount of savings built up during lockdowns has defined spending levels since 2020 as Americans (and many other people) continued to spend at higher-than-historic levels, boosting economic growth. Higher interest rates were supposed to moderate this growth, but we've found that even with higher interest rates, financial conditions have actually gotten "easier," essentially negating the typical effects of rate hikes. "Financial Conditions" are generally a combination of statistics compiled to try to gauge whether it is easier or harder to do business due to the availability and cost of financing. Simon White, Bloomberg macro strategist, writes in a March 21, 2024 article entitled, "Did You Spot The Gorilla In The Fed's Meeting Room," that financial conditions have gotten much easier during the latest hiking cycle, due to tighter credit spreads, favorable exchange rates and higher equity valuations. This is best shown in the following chart from the article that shows the gold-colored line in the top-right corner is falling steeply, showing loosening financial conditions, at the same time interest rates rose steeply (lower black line). This is in direct contrast to the past three other rate-hiking regimes since 2000, as shown in the rest of the graph, where financial conditions were tighter once rates were raised.



At the most recent March 20th Fed meeting press conference, Chair Jerome Powell said they think "financial conditions are weighing on the economy [!]," and the Fed continued to see three rate cuts this

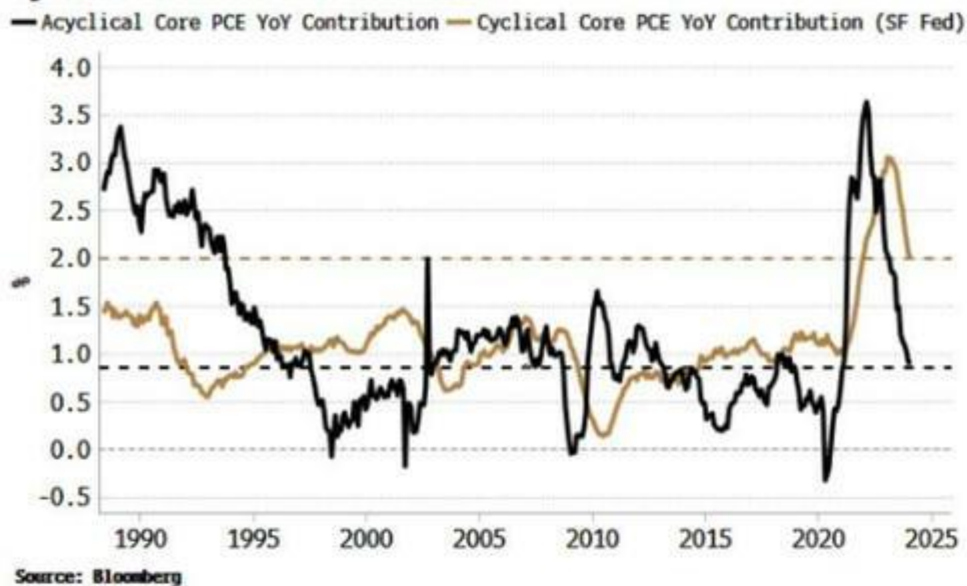
year, while still projecting annual economic growth over 2%, unemployment roughly unchanged around a 4% unemployment rate and inflation not coming back to their 2% goal until 2026. However, on April 16, while answering questions on an economic panel, Chair Powell changed his tune, declaring "[r]ecent data have clearly not given us great confidence that inflation is coming fully under control and instead indicate that it's likely to take longer than expected to achieve that confidence," according to the AP article 4/17/24, "Powell: Rate cuts likely to be delayed." While the markets have continued to embrace his early rhetoric about rate cuts occurring this year, the economy's boost from Powell's "jawboning down" interest rates last fall may be petering out.

Government Spending / Reshoring / Friend-shoring: Government spending is on fire, and government policies have led to reshoring, both of which have become engines of economic vitality which continue to chug along. The implementation of the Chips Act and the ~~Inflation Reduction Act~~ (i.e. the Green New Deal) have led to semiconductor, battery, electrical component and other plants to be built in the US to start turning out more products needed for the electric vehicle and concomitant electrical infrastructure that will need to be expanded and upgraded to accommodate so much more electrical usage and flexibility. In addition, continued tariff and geopolitical concerns have continue to move production and thus, transportation and distribution of industrial and consumer products from China to more friendly countries, headlined by Mexico. This combination of onshoring a lot more EV and green industry components while nearshoring more and more formerly Chinese production has continued to underpin US industry and thus our economy.

Indicators Showing Economic Growth Slowing: Do we still think there will be a recession? Unfortunately, we do think there will be a recession in the near future, and we are dismayed that the Fed and government have been in overdrive to avoid the onset of recession, which generally acts as a cleansing agent for the economy, cleaning out poorly run, underfinanced or just redundant businesses. However, recessions are obviously unpopular for tougher conditions that lead to business failures and increased unemployment, and people usually blame the government. By "keeping things going" using overspending (the government) and easy financial conditions (the Fed), weaker businesses continue to use resources best spent on new and/or growing businesses that could boost growth more productively. The 2-10 yield curve inversion has a nearly perfect record of predicting recessions, and it reached the lowest levels seen in more than 40 years last summer. As economies fall into recession, bond investors generally buy longer term bonds, which pushes down 10-year Treasury rates versus 2-year Treasuries, thus flattening the yield curve. Until last November, bond investors have been active in buying long-maturity Treasuries, nearly un-inverting the 2-10 yield curve as they anticipated the coming recession. Since then, the yield curve has bounced around but is still inverted, as Treasury investors still accept lower longer-term rates (10-year rates lower than 2-year rates) and still see the probability of a recession, another symptom of the game of chicken between the Fed and markets.

Retail sales were reporting 4/15/24 and while they rose 3.8% nominally y-o-y, 3.5% of that is explained by higher prices, meaning inflation-adjusted retail sales are anemic and showing that US consumption growth is slowing. Delinquencies in consumer credit, especially subprime, has trended up to the highest point since the 2008-2009 financial crisis, showing the weakness and further vulnerability of the lower income sector of the US economy. We see this as the place where we will start to see blowups, and those will lead to slowing US growth, to the point where it will offset all of the government spending, resulting in a recession later this year and into 2025. In addition, gluts in commercial real estate, combined with weak balance sheets at many small and medium-sized banks, highlight down turn risks in real estate and financial services.

Finally, of course, are the corrosive effects of inflation. As we emphasized in our last letter, a lower inflation rate merely means PRICES CONTINUE TO RISE, JUST AT A SLOWER RATE OF RISING. The politicians continue to try to sell the American people that their lives are getting better because "the inflation rate is going lower." But people's ability to afford necessities is getting more difficult, because wage gains are just now barely keeping up with price rises. And the inflation rate has come down generally due to lower energy costs and other commodity costs known as "acyclical inflation." Longer term inflation factors continue to be at 40-year highs. The following chart also from the Simon White article "Did You Spot the Gorilla In The Fed's Meeting Room?" shows that acyclical (energy/ commodity) inflation is back to its recent historical average (black line) while the cyclical Core PCE inflation is still its highest since the 1980s:



White's article also points out that mortgage cost inflation is no longer counted in inflation statistics in past decades. While rent and owner-equivalent rent are incorporated, the recent extreme rise in mortgage rates has led to much higher interest rates for homeowners with variable rate mortgages, thus tightening their personal financial conditions and leading to some distress in affording expected expenditures.

Europe benefitted from a mild winter, keeping energy prices far more muted than last winter, and allowing the Eurozone to avoid recession for the time being. But Christine Lagarde, the head of the European Central Bank (ECB), has been strident that the ECB would be cutting rates, and almost certainly at the next meeting. European economies seem to be suffering from reduced exports due mainly to muted Chinese growth, but high natural resource prices, especially higher energy prices, continue to hamper Europe's competitiveness in world markets, in spite of a weak euro. We anticipate ECB rate cuts at the next meeting, leading to an even lower euro and continued squeezing of corporate margins.

Asian economies have been more resilient, although China has tried to kickstart its economy again by flooding world markets with cheap exports as a way to try to overcome their still-falling domestic property markets. We still think the Chinese economy does not recover its vitality until they realize losses in banks, property markets and bloated state industries; however, doing so would show their

banks to be insolvent and put many more industries into bankruptcy. The Chinese government will not allow those things to happen, so instead, they will try to use time to slowly bleed out the losses and hope that a recovering global economy will help by reaccelerating the large manufacturing sector, currently running below capacity. We don't think that will work, but the following article, from mid-March, shows the damage being caused by not "taking their medicine:"

"We Should Thank God For The Communists"
MAR 18, 2024 - 09:10 AM
By Eric Peters, CIO of One River Asset Management

Thank God:

"Value investors think China is cheap, at some point it'll turn," said the CIO [chief investment officer of an investment fund], decades spent in HK, investing globally, Asia focused. "Perhaps they're right," he said, a light shrug. "But markets require capitalism, and capitalism requires rule of law." China is one of the most important wildcards to track to understand the global economy, markets, geopolitics. "Confucius believed in rule by law, with the word of a wise, moral, ethical leader being law. Mencius (Confucianism's 2nd sage) agreed about morals and ethics but argued for rule of law."

"Xi Jinping believes in rule by law; what he says is law," continued the CIO. "Now that Xi has shown his hand as he tightens his grip on the Party, economy, markets, what could he possibly say going forward that would entice any thinking person to take real risk?" he asked. "For the first time in my career, the Hong Kong tycoons have accepted that it's over," he said. "They feel the US has it in for them, and they see China as un-investable now," he said. "Their grandparents fled the mainland in '49 and taught them to never trust the Communists."

We think this small story not only shows why China will continue to suffer but also why we are not investing there currently: Xi's rule over the country now extends to the corporate sector, and they are choosing politically-acceptable solutions to try to solve economic problems, which never works for long, if at all.

Bottom line: The US economy continues to grow according to the statistics, driven by government spending and reshoring. With inflation no longer falling, the Fed has held off lowering rates as fast as they initially planned, causing short-term rates to stay the same and long rates creeping back up to multi-year highs. Meanwhile, financial conditions continue to be looser than most predicted, keeping liquidity and a bid in markets. Some deterioration in economic growth under the surface concerns some market participants, but continued growth still remains. Non-US economies have slowed throughout the world, but with measured inflation still higher than central bank targets, rate cuts have not occurred on any scale, so higher rates than many expected continue to slightly brake world economic growth. We still see recessions in the US and Europe, as lower rate instruments mature and newer, higher interest costs hurt industries across the spectrum.

Equities

Equities have stayed resilient for much of 2024, continuing their late-2023 ascent after an early January hiccup. The highflying tech sector led the way much of the time, but many of those stocks have flattened their rise or even declined as investors price in fewer and fewer expected rate cuts, and long-term interest rates continue higher toward multi-month high levels. Earnings announcements have not helped as much as many thought, as a large number of tech stocks have announced good past earnings

but have chosen to adopt cautious outlooks for future growth, cancelling out the good news of beating on earnings.

The fly in the ointment is continued earnings growth at this stage of the economic cycle. Many managements are signaling they are at an uncertain part of the current economic cycle, hoping slowing growth will morph into higher growth (the fabled "soft landing") later in 2024 or in 2025. Current stock market levels reflect a soft landing, but April weakness in US stock markets shows that investors are increasingly dubious about that result.

However, cyclical industries have taken over some market leadership as US infrastructure, reshoring and the green energy buildout require materials, machinery and manpower to accomplish all the planned projects. We have overweighted materials and industrials in Kanos portfolios to take advantage of what we think is a multi-year effort of planning, construction and operations. In addition, the continued geopolitical upsets around the world point toward maintaining an allocation to the defense sector, which we continue to do also.

In our opinion, the financial markets have maintained a "show me" attitude regarding increased geopolitical (and even inflationary) risks, which, in spite of the downdraft in 2022, continues to translate into a still-robust taking of risks in the financial markets. And, despite increased geopolitical flareups worldwide, Western stock markets continue to shrug off geopolitical threats that have not shown any marked escalation.

We thought we'd see a showdown occurring in March when the bank rescue package, the Bank Term Funding Program (BTFP), expired. There continue to be over $120 billion in securities that banks have lent to the Fed in exchange for the cash on one-year loans that appear to have not matured yet (analysts point to more of these loans actually maturing in May-June timeframe), and bank investors seem to think that bank managements for the most part have managed around these underwater securities and banks' commercial real estate (CRE) exposures. We did see the first bank failure of 2024 last week; Philadelphia's Republic First Bancorp, a small $6 billion troubled bank, failed, and the FDIC sold it to the much larger Fulton Bank. However, we are still skeptical that there is not more actual stress on small and medium banks.

The Fed's Reverse Repo Facility (RRP) that has provided much of the liquidity which has helped maintain bull markets through the first quarter has dropped significantly throughout 2023-24, down to under $300 billion after topping around $1.8 trillion two years ago. We expect this source of liquidity to slow its contribution to the US financial system, removing an impetus for the recent bull run.

Although there are negatives starting to build, and we expected the US stock market to swoon during April as bad news was absorbed, continued government stimulus, a still generous pool of liquidity in US markets, the Fed halving its quantitative tightening (QT) in the near future (we think), and momentum in the markets point to the rally having more life. In addition, the ongoing large amount of passive buying by US employees in their retirement accounts continues; US investors are counting mostly on stock markets to fund the growth needed in their retirement funds. Finally, one of the big buyers of US stocks, the corporations themselves, are in a buyback blackout period during April when 1Q earnings are announced; when the blackout period ends in late April, we expect corporations to continue their stock buyback programs, putting a further bid under the stock market.

World stock markets are acting very differently, depending on local. European markets seem to be mirroring US markets, while many Asian markets, notably Japan and India, seem to be slightly more resilient than other world stock markets. As referred to above in Economy, the Chinese stock market is finally suffering from its long-time misallocation of capital, and the increasing influence of Chairman Xi's government in economic and corporate decisions.

We continue to favor investments in energy, metals, and other commodity companies, as well as other essentials, such as pharmaceutical companies, defense companies and infrastructure companies (steel, materials, engineering), and some select technology, consumer staples and other healthcare firms that show attractive fundamentals, financial ratios and price action. These companies all provide essential needs in economies worldwide, and don't need booming economic expansion to thrive. Replacing and enhancing US infrastructure, building plants for strategic products (reshoring/Chips Act), and rebuilding our military stockpiles will require more materials. The materials needed and the growth of industries accomplishing those tasks require constant supplies of commodities of all kinds, which will keep a bid in materials, processing and engineering companies of all types, even if world economies slow down, and some sink into recession. Harder-to-find and more costly commodity sources will be needed worldwide, which we believe will keep many of our portfolio companies profitable and busy for years to come. We will also be looking for attractive situations in other parts of the stock market as the summer rally gets going.

Bottom line: The stock market has advanced for much of 2024, but many stocks have stumbled in April, causing a downdraft in US and many world stock markets. We believe this is due to higher-for-longer interest rates, more uncertain corporate earnings growth and future liquidity concerns. While we believe there will be a recession either later this year or into 2025, we also think that Western stock markets have at least one more run higher in them mid-year as liquidity stays plentiful, the government and industries continue to spend/build facilities and buyers/buyback programs continue to find the stock market attractive.

Bonds

US bonds have slid through most of 2024, and April is no exception. After a brief rally during the second half of March, the 10-yr Treasury yield has risen from 4.18% to 4.67% at this writing, reaching as high as 4.74% in late April. What is causing this? A toxic combination of rising inflation and a healthy supply of bonds. The US Government continues its spending spree, running up debt at a $1 trillion per 100 days clip, foreigners are net sellers of Treasuries and the Fed is divesting Treasuries from its balance sheet through QT. With inflation creeping up from an early 2024 bottom, buyers are less and less enthusiastic about adding to their holdings, with mid-April 3-year and 10-year Treasury auctions stopping through their initial "when issued" yields by 2.0 and 3.1 basis points, respectively, which is a lot.

With excess supply and waning demand, we are net sellers of bonds still through letting our current holdings run off through maturing. We have bought very short-term Treasuries (T-bills) for customers with short-term cash needs, but have sold our other positions in longer-term Treasuries due to their unattractive near-term technicals, and their susceptibility to inflation. We do think there could be a short-lived knee jerk reaction higher in Treasury prices (lower Treasury yields) if/when the Fed announces rate cuts, but with that being postponed meeting after meeting, there is little incentive to own them as all geopolitical tensions around the world seem to be ignored by US financial markets.

Corporates, especially investment grade bonds, have performed slightly better than Treasuries, as investors see the corporate sector as more prudent than government spenders, but even corporate bonds have shown losses in the first quarter and into April. High-yield bonds performed very well in the first quarter, moving higher with equities, but they have fallen in April as the equity market corrects. None of these markets is currently attractive to us, although some clients still hold some corporate bonds for income and stability. The only other bonds to have done well this year are US Agency mortgage bonds, which have stayed profitable as the housing market has held up, in spite of higher mortgage rates. We do hold some mortgage REITS due to their high yield and the still-healthy housing market.

International bond markets are slightly more interesting, but a strong dollar has spread inflation and pain to world bond markets, making us less interested in looking for bargains abroad.

Bottom line: We still believe that inflation, credit and supply/demand risks in bonds outweigh their stability and higher recent yields. Money market funds and short-term Treasuries still pay the most on the curve, attracting our portfolios with near-term cash needs.

Currencies

Changes in interest rate perceptions have led to more excitement in currency markets, and we expect that to continue into the summer, at least. The Bank of Japan's (BOJ) recent interest rate hike that moved rates up only 0.10% led currency traders to doubt the BOJ's resolve about raising rates in the near future, which it had "telegraphed" would be going up last fall/winter. By raising rates the minimum amount possible, the BOJ failed to convince traders that they were serious about higher rates; thus, traders have been selling the yen during April, eventually falling to 160 yen/$, a level not seen in 39 years. Despite Japan's Ministry of Finance's (MOF) threats that they would intervene in currency markets to support the yen, traders have continued to sell the yen, and efforts to "jawbone" support have failed. We expect the yen to fall further, due to all the reasons above continuing, although we also expect that the MOF might intervene at times, causing panic buying, before the downward slide resumes. Only if the BOJ gets serious and starts raising rates further do we see the yen appreciating.

The same could be said of the euro. The ECB's head, Christine LaGarde, has said on multiple occasions that the next move of the ECB would be to cut rates, and although European stock markets have been rising, economies are moribund, and traders expect the ECB is expected to cut before summer. This has led to a weakening of the euro versus the dollar, which we see continuing as the ECB cuts before the Fed, incentivizing yield-maximizing investors to move capital to dollar-denominated debt that is higher paying. These dynamics make the euro an unattractive place to be investing currently.

In addition, the Chinese economy is at a near standstill in growth, with the government trying to goose exports as much as possible to offset the still-faltering domestic real estate sector. To further incentivize Chinese business, the Peoples Bank of China (PBOC) has been easy on rates and increasing money growth, which also serves to incentivize traders to push down the value of the yuan, especially against the US dollar, which makes Chinese exports even more attractive in world markets. We don't see the Chinese economic situation changing quickly, so we expect the PBOC to continue with easy money policies which will keep the yuan relatively cheap and thus more competitive globally.

All this currency weakness from other large world economies means the US dollar has rallied back up to multi-month highs, and we believe the conditions will continue for at least the next few months. A high dollar means US exports are less competitive, allowing China and many other Asian and European exporters to continue to dominate world trade, as evidenced by their continued trade surpluses. And the Fed's continued fight against US inflation means they will have to keep rates higher for longer, despite their stated desire to lower rates as soon as practical, so we see the dollar continuing to gain against almost all rivals. This favors our cash being in short-term dollar fixed income investments.

The weaker yen and yuan have had an effect on other Asian and European currencies, as weaker export economies around the world try to compete with their heavyweight Japanese and Chinese competitors. A higher dollar weighs on these countries as dollar-denominated commodities, especially energy products, make costs go up and make inflation a continuing and possibly growing problem. Thus, we have no interest in investing in smaller currencies.

Bottom line: The US dollar will continue to strengthen as world exporters fight for market share and try to boost their economies with lower interest rates sooner than the US. Volatility and the vulnerability to upset around the world makes us shy away from currency investments at this time.

Commodities

Commodities have come to life during March and April as US government infrastructure, energy and defense projects combine with private sector reshoring, development and expansion of Western Hemisphere plants, mines and energy infrastructure to boost demand for most commodities.

Metals have been especially strong, with many base metals climbing to their highest since the Russia-Ukraine war outbreak spike, and precious metals have taken off, as discussed below. We think it is instructive to hear a couple of different viewpoints on why metals have boomed during early 2024. Here are two distinctive X (formerly Twitter) threads that we think give very good explanations of the strength in metals prices.

Bob Elliott, a fund manager and Chief Investment Officer of Unlimited Funds in New York, wrote a cogent series of tweets on X on March 5 giving an attractive investment thesis for gold and gold mining stocks. I have reproduced his work here because I thought it was illustrative of why we also like gold and mining stocks as so attractive; it is a series of 14 posts:

1/Gold pushing new all-time highs despite broad hatred in the US, higher dollar, and tighter dollar US monetary policy expectations suggests the surge in demand is from abroad, particularly China. Gold price is rising even as US ETF assets keep falling: **[Notice the purple line which illustrates the total holdings of US ETFs that hold gold bullion; normally, when the ETFs are selling bullion (purple line going down), the price is dropping. But during 2024, gold prices are rising as US/Western world ETFs are selling – Asian buyers appear to be buying all the Western sales volumes – comments ours, KS]**

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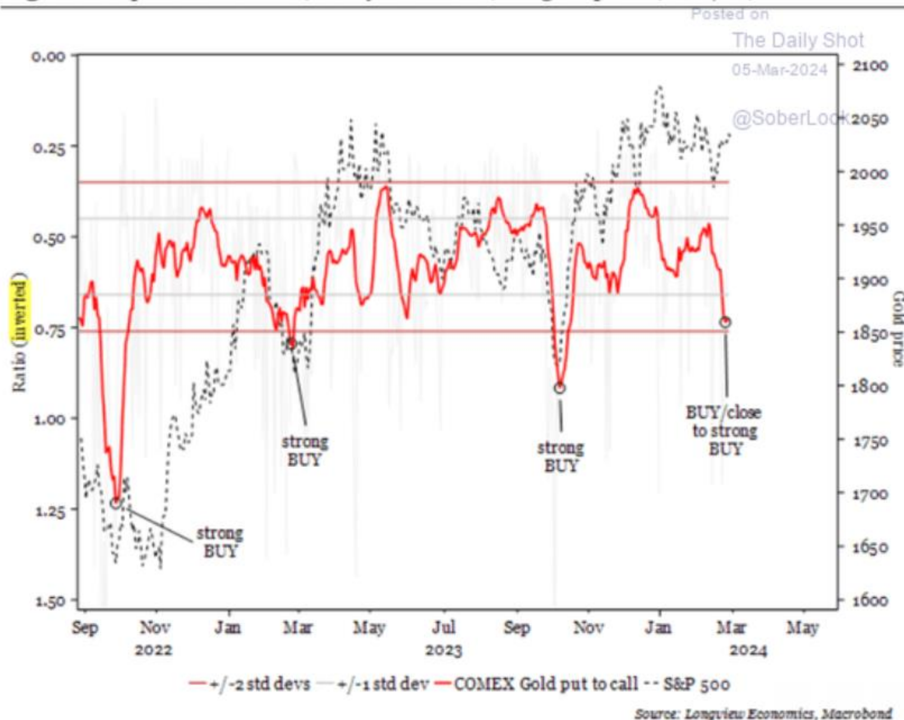
2/Gold price rising despite the put/call ratio being deeply bearish on gold:



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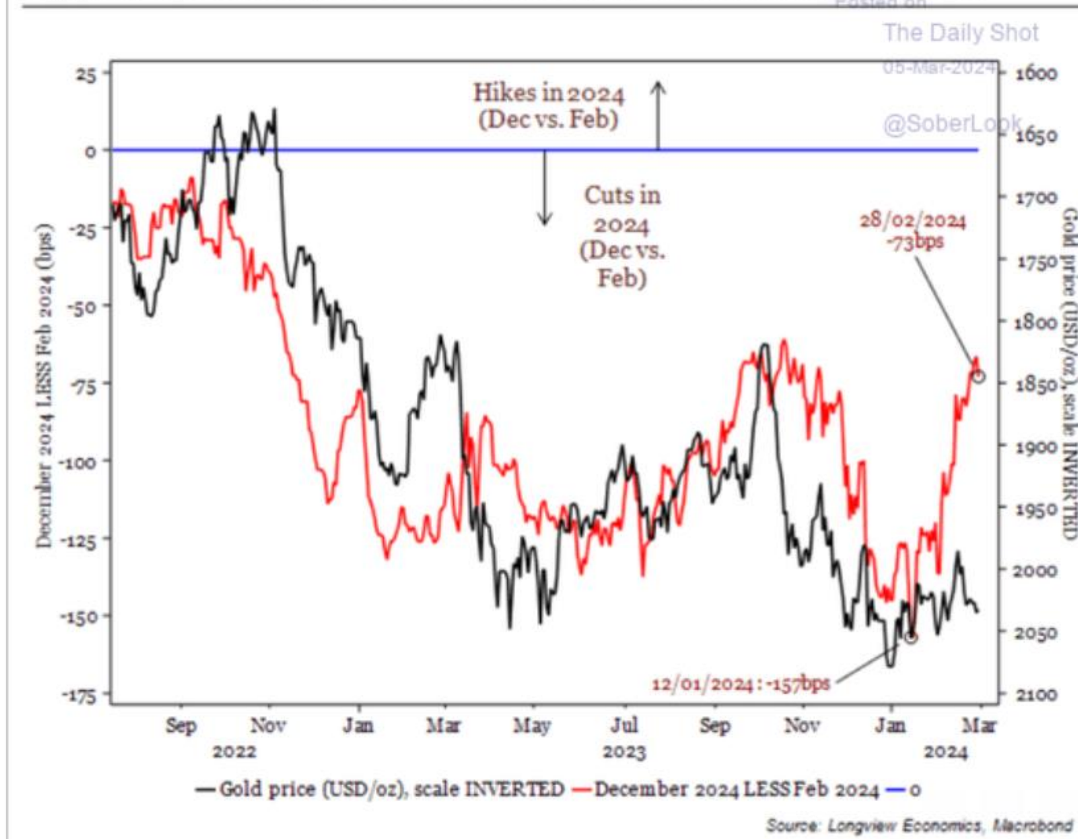
3/Gold price rising despite miners being pretty unloved in the US equity markets…

4/Gold prices staying elevated even as the market has significantly unwound much of the previously expected easing.



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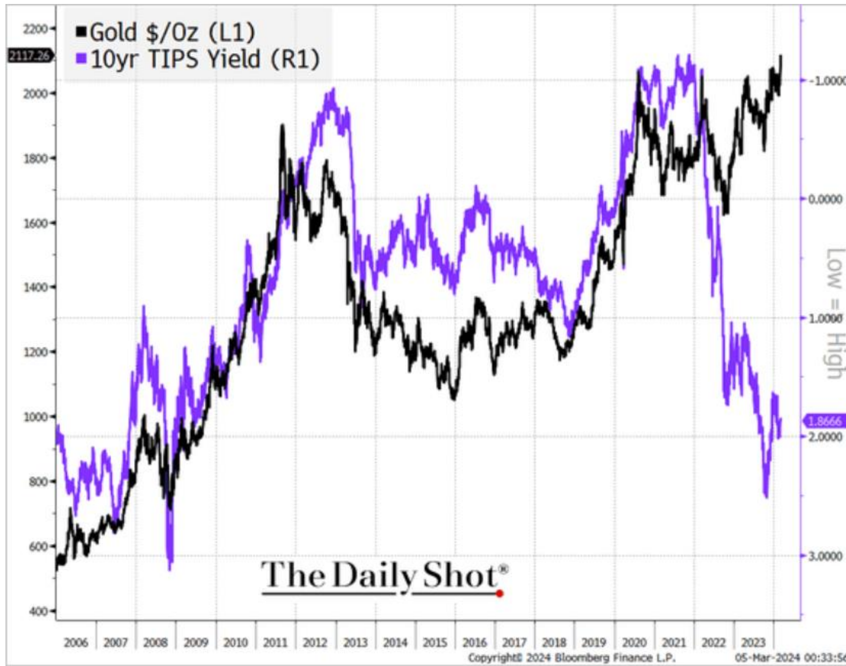
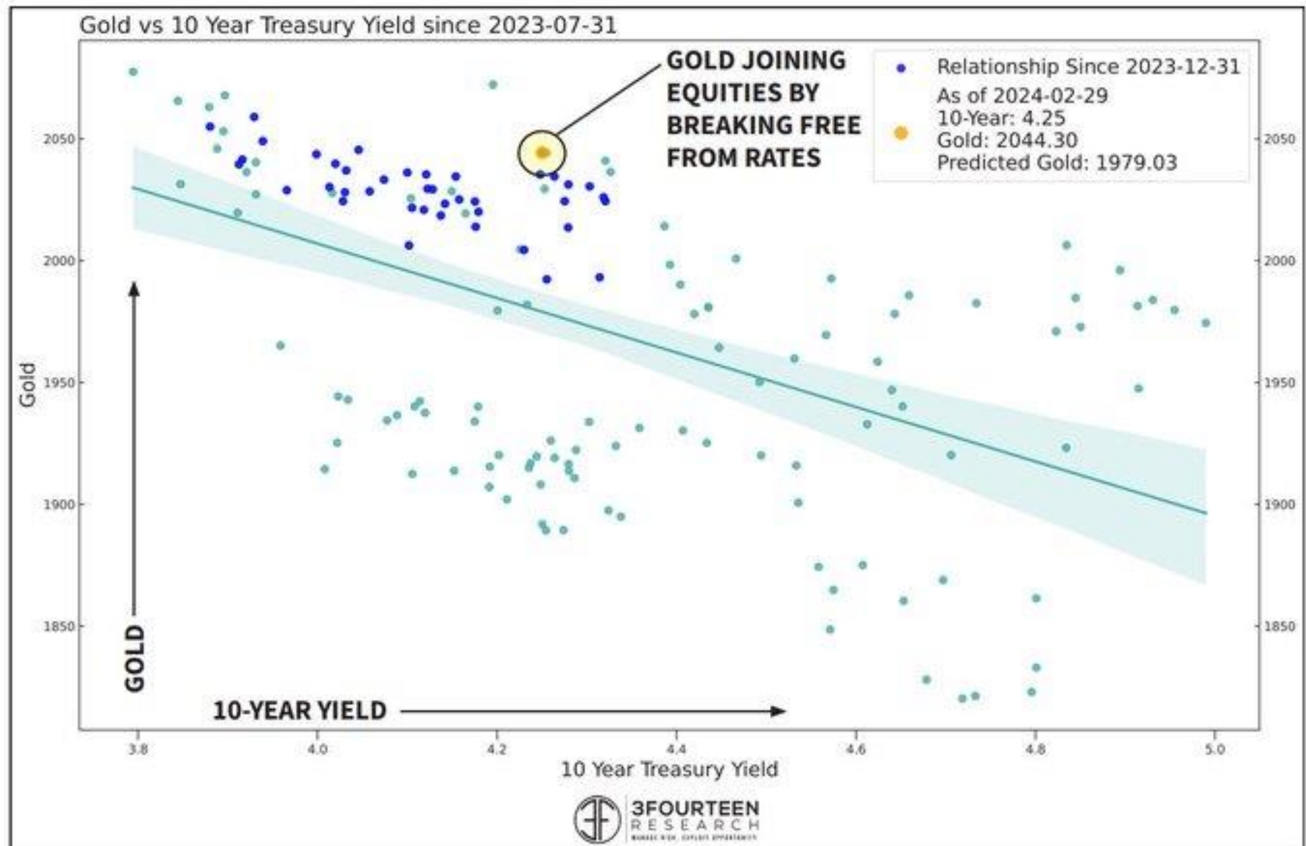
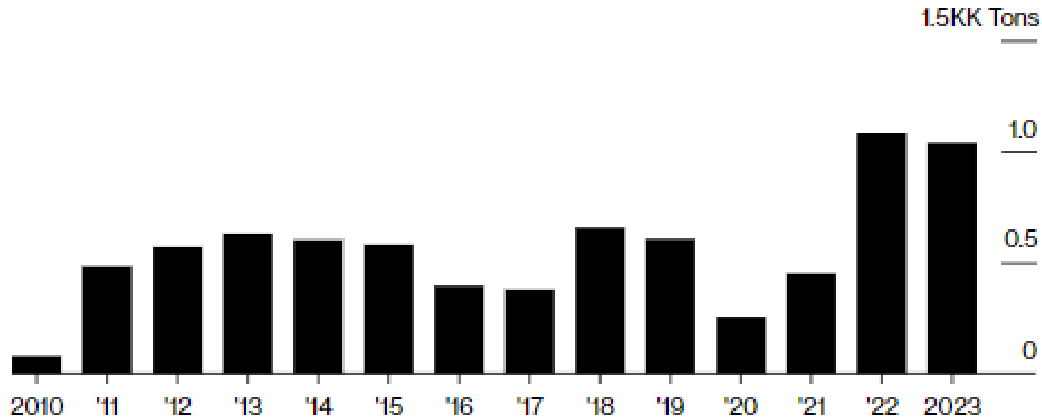
5/Gold pushing new highs despite long end real yields remaining at multi-year highs.



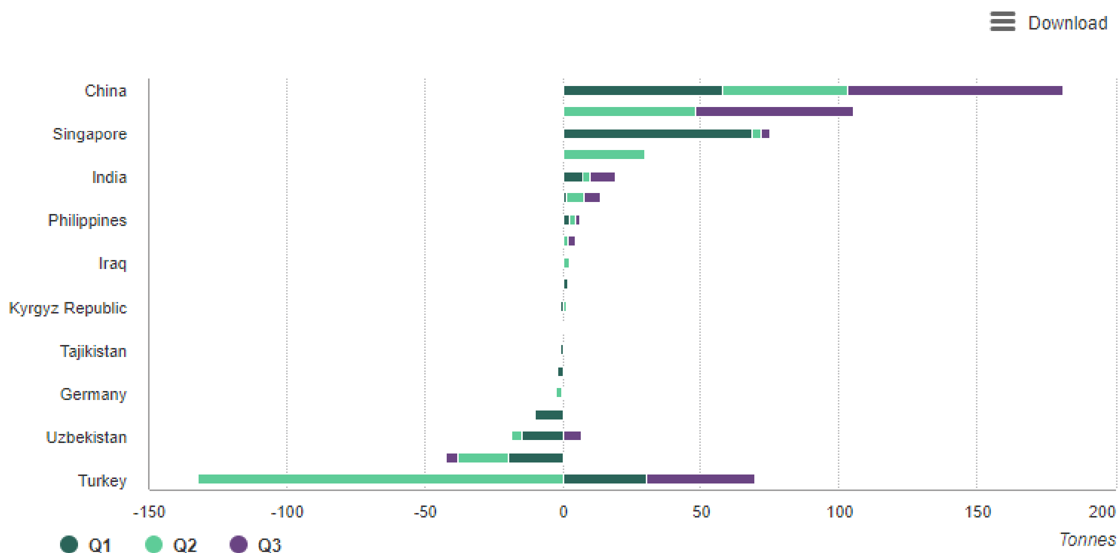
6/Seeing a real break here of gold prices from yield dynamics relative to history.



7/How can it be pushing new highs despite being so unloved? Simple - foreign demand. We already know foreign central bank demand for gold has been incredibly strong the last couple years, and odds are this is continuing into early '24.



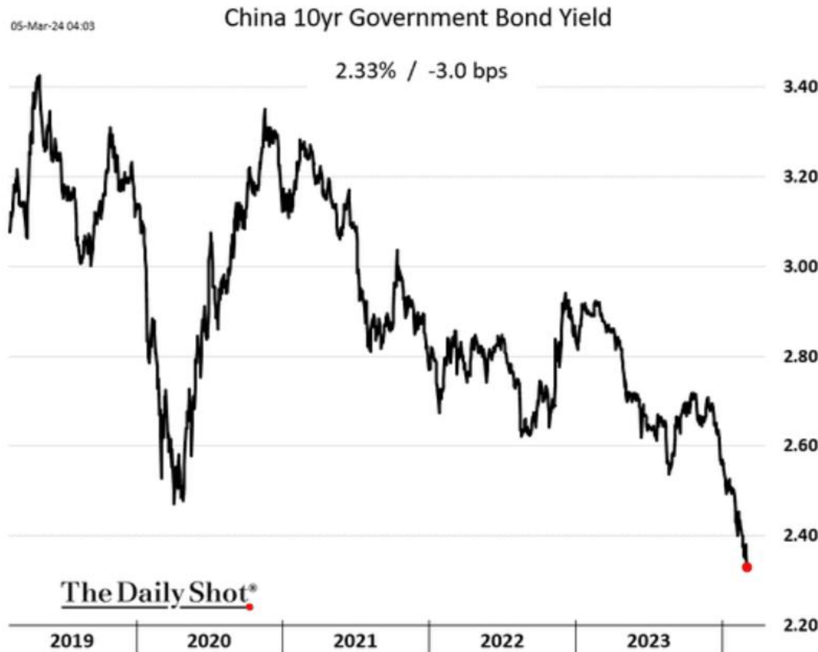
8/With China buying being the most substantial. And this is the *reported* demand. Odds are they are taking a lot more out of domestic supply than shown here.



9/Also seeing the Chinese onshore gold premium remain quite elevated despite being a bit down from all the noise late last year.

10/We can also see some hints of it in the overnight market action... This is just today so don't read too much into it, but have been seeing these overnight buying sprees occurring in recent months.

11/In many ways, we may be seeing in the gold market the state of *Chinese monetary policy* is much more impactful than that of the US, even in dollar terms. While US rates have remained high, Chinese rates have fallen a lot...



12/And gold in CNY making new highs.

10 Year Gold Price History in Chinese Yuan per Ounce

13/The dynamics in China and the pressures on global central banks to diversify are all pretty strong forces that underpin strength in the gold market. But appreciate will be softened by the continued hatred of gold in the US market.

14/If that US demand picture shifts even a little bit - from active selling to even neutral - there is a significant possibility of an effective short-squeeze upward, which could be further support by a shift to easing by the Fed (possibly too early).

15/Risk of course is that the bond market gets spicy on the long-end and starts to rise further leading to stronger dollar and tightening USD liquidity....

The second gold thread on X comes from Jared Dillian, an ex-Lehman ETF trader and now a financial writer, summing up the other aspect of gold demand presently. Gold has been climbing in price at a time when real interest rates are falling and the US dollar has continued to show strength (against the euro and Japanese yen, especially), two financial influences which in the past have served to pull down gold prices. Why is gold rising? Jared explains below in a series of 13 posts from April 4, 2024:

1/Gold has been called lots of things, like an inflation hedge. It is an imperfect inflation hedge, at best. It has been called a store of value, a disaster hedge--it has been called all sorts of things. What it really is, is protection against debt monetization.

2/Debt monetization is when the government runs out-of-control deficits, interest rates skyrocket, and the central bank is asked to cap interest rates in response. Rates are capped by the CB being willing to buy all available bonds at a given price.

3/With printed money, of course. The money supply explodes, inflation skyrockets, and investors flock to hard assets, like gold, but also pretty much all commodities. There is plenty of historical precedent for this.

4/This is exactly what happened in the hyperinflationary episodes in Weimar Germany and Zimbabwe. Argentina is fighting it as we speak. Not to say that we'll get a million percent inflation here, but even 9 percent inflation was pretty painful.

5/A government bond is a claim. It is a claim on some asset, and that asset is the productive abilities of all the citizens in the country. When the supply of claims exceeds the supply of assets, the result is inflation.

6/This is the main reason gold is rallying right now--interest expense is spiraling out of control, and if interest rates tick up 1 or 2% higher, we will be in fiscal checkmate. The only path forward will be debt monetization.

7/So anything that increases the probability that we will monetize [US Treasury debt] makes gold go up, and anything that decreases the probability that we will monetize makes gold go down. You're probably noticed that rates and gold are now positively correlated. Why?

8/**Because when interest rates go higher, it actually increases the probability of monetization. In a normal environment, high rates are bad for gold because gold yields nothing in comparison. Now, high rates are actually good for gold. [Emphasis ours – KS]** Few understand this.

9/Gold responds to a number of different economic variables, but the one that it has the highest correlation to is budget deficits. When deficits are large (like 2009-2011), gold goes up. When deficits are small (like 2011-2016), gold goes down.

10/The one thing we know about the 2024 election is that no matter who gets elected, the deficit is likely to get even larger. Outside of some big disinflationary impulse, we are likely to get much higher rates. And if we get a war--Katy bar the door.

11/There is historical precedent for that, too. The Fed pegged the yield curve during WWII, and after it lifted the peg, inflation went to high double digits. Gold was not freely floating at the time.

12/I have always thought debt monetization was possible since we started QE in 2008. And it's worth talking about QE. How is QE different from monetization? With QE, you set aside a finite amount of money to buy bonds. With monetization, you set aside an infinite amount.

13/We've been inching closer to this for the last 16 years. Things always take longer than you think in finance, but I wouldn't be surprised if we're doing full-blown monetization in 2024-2028. That is the endgame.

Jared believes the Fed will have to cap interest rates through monetization of the debt, a program of buying US Treasuries that is similar to quantitative easing, but for different reason. He makes a good argument why monetization would be further good news for metals, especially gold.

As gold prices have climbed to new all-time highs, at least some Western organizations have paid attention: banks. In April, Goldman Sachs has raised their target price on gold to $2,700/oz by year-end, while UBS has projected $3,000/oz. Bank of America believes gold will reach $4,000/oz in the next couple of years, based on current trends showing no sign of changing over the next year or two.

Precious metals mining stocks have not performed as well as gold has during the current rally, as investors worry that miners' managements will not be able to improve profitability as extraction/energy/personnel costs rise along with metals prices. In the last metals rally (2005-2012), this ended up largely being the case – managements believed they had a hunting license to find gold, whatever the cost to extract it. As costs started to catch up with advancing metals prices in 2011-2012, profitability peaked and rolled over, squeezing profit margins and sending share prices lower.

This experience scarred metals investors, boards and financiers. All the "imperialist" management teams were fired, and new, more responsible financial managers have replaced former managements. Current managements are focused on extracting metals profitably, and financiers have been ruthless in extracting value from companies when doing financings to cover cost shortfalls, making managements think multiple times about which mines to develop, formulating realistic budgets that can be realized and paying dividends to prove to investors that there is enough cash flow to grow as well as pay owners. It is a very similar dynamic to oil and gas producers – empire building is over; develop new resources in a financially responsible manner and pay out a good part of the realized returns. Lastly, we are investing more in companies that are developing high grade mines, where you move just as much rock but recover more metal per ton. Mining higher grade mines is much better economically and once in operation, are less risky. While these opportunities are harder to find and more expensive to develop, we find that they are better investments than other stocks, and that they will benefit even more from the current (and future) inflationary financial environment.

As discussed in past letters, we believe that growing demand for copper, nickel, tin and rare earth metals will drive more exploration and business activity for base metal miners. More traditional metals like iron ore and other steel materials like metallurgical coal, etc. have also seen good demand from US infrastructure projects, so we also are attracted to their prospects and the companies that produce and use them.

Agricultural commodities have not done as well as we thought, but some smaller ag markets have caught fire. Cocoa prices have skyrocketed as supplies from West Africa and Ivory Coast have suffered damage, at least in part from El Nino weather affects during the latter half of 2023/early 2024. Cocoa plants take multiple years to develop into mature producers, so recent damage is expected to last into next year at least, leading to very high prices for the base product of all chocolates. Coffee has also risen strongly in price as Vietnamese production has been cut by adverse weather. These examples show that even relatively large markets with multiple sources can be upset when one major source suffers; in a world where world trade is getting more difficult and more dangerous, upsets like those in cocoa and coffee will continue to feed inflationary impulses that affect many everyday products' prices.

Bottom line: In many commodities, we continue to think that supply constraints will help protect our portfolios' companies from cost inflation that plagued the last bull market. We are interested in metals, other construction materials and a number of ag products and inputs (fertilizers). We find the precious metals, especially the mining companies, the most attractive segment due to its undervaluation relative to history and its ability to grow earnings in an inflationary, higher interest rate environment with growing uncertainty in domestic government finances and geopolitics.

Energy

Energy rebounded from being the worst performer in the fourth quarter of 2023 to being the best sector performer in the S&P 500 this past quarter. Why? The fourth quarter was characterized by an overhanging pervasive attitude that world economies were slowing, thus forcing down demand and causing a supply glut. In the first quarter, demand continued to grow and supply grew more slowly than widely expected, bringing on the growing supply shortage anticipated by some private analysts we read. Thus, prices have increased across the board, and the energy stocks responded.

With that in mind, the WTI crude oil market closed March trading at $83.17 per barrel, up 16% for the quarter, but still a far cry from the $100+/bbl seen after the Russian invasion of Ukraine. Analysts are more concerned about refined products, which appear to have fallen into a larger supply deficit during "refinery turnaround" season this spring (refineries do maintenance in spring and fall when demand is lowest). Not only are western stocks of refined products lower than normal during this time of year, Ukraine attacks on Russian refineries have idled a large amount of refining capacity, further tightening worldwide supplies. In the past few months, Ukraine drone strikes in Western Russia have struck thirteen refineries, causing as much as 800,000 bbls/day of refining capacity to be offline currently (according to S&P Global Commodity Insights), and in some cases, damage is slow to be restored as Western sanctions make procurement of replacement parts more difficult. Growth coming out of developing countries seems to be consistent, contradicting the IEA's forecasts of faltering demand during late 2023-early 2024.

In our analysis, the continued underinvestment in both upstream (new supplies) and downstream (pipelines and refineries) will continue to drive attractive supply/demand dynamics for the foreseeable future. Both the IEA's and private sector's forecasts of a supply glut have proven incorrect, and the only real move down in prices happened when the Biden Administration (and other western governments) emptied much of the West's strategic petroleum reserves in the aftermath of a prolonged Russia-Ukraine conflict. Since then, even with relatively high production by both Russia and OPEC and now Iran, world crude supplies are in a slight deficit, and gasoline, distillates (diesel and heating oil) and other products are in even shorter supply. We are still bullish on crude and products, and we will continue to look for attractive ways to find value in the petroleum complex.

Natural gas has been a real laggard in the energy complex, hamstrung by warmer weather in the Northern Hemisphere due primarily to El Nino weather events. Natgas dropped below $2.00/MMBtu in February and has stayed there due to continued moderate North American weather and overproduction due to high oil prices (natgas is often produced with crude oil – since crude prices are relatively high, US discretionary wells are being produced for oil revenues with the co-produced natgas sold at spot, regardless of the level). In fact, in the Permian Basin of Texas/New Mexico, oil production is so high that there is not enough pipeline space to transport all the co-produced natgas that the price has dropped below $0 (specifically, Waha natgas was trading around -2.00/MMBtu in mid-April – you were paying a buyer $2.00/MMBtu to take the gas off your hands!).

Coal will continue to be an electric generation solution worldwide, especially in India and China. China has 20+ coal-fired electric generation plants coming online in 2024, with another 30+ under construction or planned for operation in 2025. India is also building out coal-fired generation as more and more Indians join the twenty-first century economy that requires more and more electricity to operate

efficiently. We still find US coal companies attractive, as 20% of US electricity is still generated by coal plants, and US companies are expanding exports to Asia and Middle East exports markets.

Bottom line: We own supermajors, exploration and production companies, refiners and pipeline companies, all of which continue to provide safe reliable energy supplies at market prices from domestic and international locations. We own some select coal producers and may increase our investments in these generally cheap investments. Our investments are picked for their potential for capital gains, current yield and possibility of acquisition by larger entities. Fundamentals are still very attractive, and we expect energy investments to outperform again in 2024 and beyond. Market expectations of energy usage slowdowns have not been realized, as energy usage worldwide continues to grow to new records.

KANOS
CAPITAL MANAGEMENT, LLC

Kanos Quarterly Commentary

The World Has Changed – Part II (They're Heeeeere!)

For those involved with popular culture in the 1980s, no one can forget young Carol Anne Freeling in the 1982 movie Poltergeist looking back from the television set and declaring: "They're Here!" Once you saw it, it was iconic. And it was scary, both the horrifying images that appeared on the screen and the unknown ones soon to follow.

We are being melodramatic because the economic situation in the US is not "Poltergeist-ian," but we do not think the sentiment is misplaced: the situation the Fed has gotten itself into is a no-win potential horror show.

As we all know now, the incredibly large Fed stimulus and accompanying governmental spending and support after the government imposed Covid lockdowns in March 2020 translated into a subsequent overheated economy and resultant inflation. The Fed judged the inflation to be transitory and did not adjust interest rates for years, resulting in a "catch-up" tightening cycle that was the fastest in modern history, to fight inflation and to try to cool the economy somewhat. While the rates did get up to a level above what many economists believe to be the "neutral rate of interest" (the point at which interest rates change from being stimulative to being restrictive), other parts of the financial markets, namely high stock prices, tight credit spreads, lots of available credit [albeit at high cost of interest], etc. has led to looser financial conditions than the level of interest rates would normally signal, allowing many financial markets to further boom despite "restrictive" rates.

The stock market came out of its "rate hike adjustment" bear market of 2022 and part of 2023 to soar to new highs during 2024, with a number of stocks, led by the 'Magnificent 7,' roaring to heights rivaling the 2000 dot.com bubble. Wartime-level government overspending, consumer overspending goosed by using Covid-era extra savings, and the promise of new technological advances, most notably AI, pushed markets higher and higher. Employment has stayed high as large amounts of government spending has allowed people to find governmental / stimulus-supported industrial / service jobs at a clip rarely seen in the past few years.

However, this is where the situation could turn scary. For the past 35+ years, when either the economy slows appreciably (potentially stalling into recession) or there is another problem in financial markets, the Fed has used short-term interest rates as its "accelerator," to try to speed up the economy.

While the stock market has continued higher (correcting a bit in April), the underlying US economy looks to be losing steam, with inflation-adjusted retail sales and real estate transactions starting to slowing down. High mortgage rates compared to recent history has made houses for first-time homebuyers much less affordable. Food prices have risen 20-30% in the past couple of years without any real respite. Energy prices were high but backed off for much of 2023, but now they are climbing back toward multi-month highs, especially gasoline.

The Fed would obviously like to cut rates to help the economy not slow down so quickly, as it has done countless times in the past three decades. However, it must respect its dual mandate of 1) full employment and 2) stable prices. So, here's the conundrum – the economy is statistically doing well:

employment is at or near full, the markets are rising and inflation had been trending down consistently. But now, inflation is trending higher, economic statistics are trending lower, energy prices are noticeably higher and consumer confidence is near its lowest in years. If the Fed cuts, they will be goosing inflation at a time when it's a hot button issue for the coming 2024 elections.

We have continued to emphasize the problem of inflation. When globalization was finding newer, cheaper countries to continue to drive down the costs of goods and services from the 1990s through the 2010s, the Fed had the luxury of lowering interest rates whenever they deemed the economy "needed" lower rates, and they could speed up or slow down the economy in a way that appeared to be all their own doing. When the excesses of credit creation led to a crack-up in 2008-2009, the Fed again had the luxury of introducing what came to be known as quantitative easing, where the Fed bought both government and private (mortgage) bonds for new cash injected into the financial system, creating extra stimulus over and above zero interest rates to further stimulate a sluggish economy, again without appreciable (measured) inflation, due to an overabundance of ever-more-cheaply-produced goods and services that were further offshored to even cheaper countries that kept prices (and worker wage gains) in check. Federal deficits increased only gradually where growth was somewhat kept in check by a series of split US governments, punctuated only occasionally by one party rule (where the Presidency and congressional leadership were all one party).

However, the Covid lockdowns and the extreme reactions and later "solutions" to the economic distortions upended this situation. Deficits have soared as the government has started to dictate far more policy and to provide more and more handouts to citizens and now non-citizens. Geopolitical politics has spiraled out of control, involving the US in proxy wars in Ukraine and the Middle East while starting to kindle in other parts of the world as well (East Asia/China, Guyana, Haiti, etc.), sapping military preparedness, weapons and ammunition stockpiles and even the mighty US military budget.

The combination of more liquidity in the financial markets, coupled with still higher-than-tolerable inflation, growing geopolitical trouble and the current Administration being behind in the reelection polls means things seem to be coming to a head. This came into even better focus with the recent release of the proposed future budget out of the White House. The Congressional Budget Office (CBO) and the Fed's staff of accountants have also released their projections on future budgets of the US government. According to the article "Three Fantasyland Budget Projections By the Fed, Biden and Congress," by Mike Shedlock on MishTalk.com on March 19, 2024, the CBO budget projects this fiscal year [2024] at $1.6 trillion, which grows to $1.8 trillion in fiscal 2025 and grows to $2.6 trillion by 2034. How? Spending varies between 23-24.1% of GDP while revenues (taxes) vary between 17.1-17.9% of GDP, of course with no recession being accounted for (which would make these deficits far worse). But to finance this, Treasuries held by the public would have to increase from 99% of GDP to 116% of GDP by 2034, which would be the highest in history, even including wartime. This kind of spending is almost certainly going to put even more inflationary force to work in the economy, and since Japan, China and the Arab world have been cutting back on their US Treasury holdings, who will buy all the increase in debt? It will almost certainly have to be partially bought by the Fed, since the volumes are so large. The restart of quantitative easing in a no-longer-deflationary world will also increase inflation.

But if this inflation forecast from continued US budget deficits can be mitigated, are we out of the woods? As discussed above, Japan has become the last country (and the longest tenured one) to end negative interest rates and is expected to eventually raise rates to a point where Japanese banks are beginning to be incentivized to lend after many years (decades?) of financial repression due to deflation.

Increased industrial activity has finally led to more positive interest rates, but despite this good news, rising Japanese interest rates also means repatriation of Japanese capital. This increasing economic growth has already emboldened labor, who is asking and getting large percentage raises after years of suffering from no wage growth at all. This, unfortunately, is inflationary in a place where deflation has been the norm for as long as thirty years.

So, inflation is ingrained in the US and even bubbling up in Japan, "the land that inflation forgot." In addition, world industries are dealing with increasing inflation as dollar-denominated commodities costs more and more as the US has kept interest rates high, boosting the US dollar versus virtually every other currency.

<u>What is the Fed to do?</u> They are in that scary place where: 1) if they cut, they cause more inflation and the US population and the incumbent politicians scream at them to do something! 2) If they do nothing ("higher for longer," the current policy), they continue to fight inflation, at least somewhat, hopefully the markets remain near highs and people earn decent interest on their savings, but the Fed risks slowing the economy too much and tipping it into recession if they don't cut rates fast enough if the slowdown accelerates, or 3) rising inflation and a still-growing economy could signal that they need to RAISE interest rates. This is politically a non-starter scenario that could really backfire if the economy subsequently slows appreciably after they raise rates. The one thing they absolutely do not want is the blame for a recession because they raised rates into a slowdown. So, two scary scenarios 1) higher inflation and 3) lead to more public outrage, leaving 2), the "do nothing" scenario as the least scary and the least embarrassing for Fed officials.

Finally – <u>what WILL the Fed do?</u> We believe that, as always, the Fed will wait for a crisis, virtually any crisis in the financial markets, or even one possibly in a geopolitical situation that directly affects the United States, to cut interest rates. Despite the specter of increased inflation, the Fed has not learned that <u>times have changed radically</u>, and that earlier solutions during non-inflationary times are no longer appropriate now. They will use the same solutions because they react to the politics around them and ultimately, they crave acceptance, giving Washington and New York easier conditions, as they always have, and they will deal with the resultant inflationary implications later, or even better for them, leave the mess to the next set of FOMC members.

The Managers of Kanos Capital Management
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