Kanos Capital Management

Quarterly Investor Letter

Second Quarter 2024

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CAPITAL MANAGEMENT, LLC

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Second Quarter Market Review

The second quarter was dominated by three themes in the financial markets: 1) Artificial Intelligence and its further development, 2) the timing of Fed (and other central bank) rate cuts, and somewhat relatedly, 3) the timing of any slowdown in the US economy and corporate profits. As most have seen, market participants concentrated investments into the AI sector, sending Nvidia to $3 trillion in market cap (briefly), but also elevating Apple, Microsoft, Alphabet (Google) and Meta to large gains on the hopes that AI functionality would build traffic to these companies' products and sites. "Purer" AI plays like Super Micro and Dell (servers) as well as Broadcom, Micron and Taiwan Semiconductor also benefitted. However, as inflation temporarily waned and financial conditions loosened, investors moved money into both infrastructure and hard assets, led by precious metals, base metals and infrastructure companies, with losers being energy (after beating most other assets in the first quarter) and international bonds (as overseas central banks started their easing cycles before the US Federal Reserve (the Fed) did).

Looking Forward

Introduction

Going forward, we see the recent themes of the stock market continuing to be the prime drivers of stock prices. Notably, while stock prices of AI have corrected in July, AI spend does not seem to have backed off, so we think we will continue to see lots of attention on these companies, with earnings announcements and forward-looking forecasts fine-tuning investors' expectations toward future prospects. But there is a good chance investors will be disappointed when large tech stocks report earnings with little to show for the tens of billions of dollars poured into their AI/large language model efforts. Secondly, while we believe we could see some continued moderation of measured inflation, which has already pushed investor expectations to a September rate cut, there are still lots of inflationary pressures around that could cause inflation to start to rise again. Finally, economic statistics, most notably job growth and consumer spending, have been slowing for weeks/months, and we believe imminent second quarter earnings reports could further highlight the US economy's slide into recession, contrasting with first quarter earnings which pushed tech stocks higher to record highs in Standard & Poor's 500 and Nasdaq indices in recent days/weeks.

Economy

In spite of decent GDP growth during the first few months of 2024 (confirmed by the recent preliminary 2Q GDP report of +2.8% growth), recent economic statistics point toward a slowing economy, including rising weekly jobless claims, continued weak Fed regional surveys, Purchasing Manager surveys and retail sales. While corporate profits held up through the first quarter, many

second quarter earnings reports so far are less rosy, especially when looking at consumer oriented companies such as banks (like Wells Fargo), food companies (like Pepsico and McDonalds) and consumer companies (like Verizon), all of which disappointed with their recent earnings announcements / guidance calls.

Despite this evidence of slowing, the economy has been underpinned by 1) continued fiscal support by the US Government for infrastructure buildouts (in road/bridges, electric grid and electric vehicle charging systems, and large-scale solar and wind projects, to name a few), 2) defense expansion and upgrades (as well as foreign military aid, most notably to Ukraine and Israel) and 3) technology development (of all types, including AI and semiconductor factories). Employment statistics, while showing deceleration from last year, continue to show new jobs being added to the economy, although the more data-intensive household survey has shown some months of job losses lately, muddying the optimism held by those claiming continued employment growth as a bright spot in the domestic economy.

Finally, inflation statistics have reported a slowing of inflation, with overall CPI inflation reported to have dropped to 3.0% year-on-year in June, and reportedly -0.1% drop in prices month-over-month. The frustration with most Americans is that while economists and government economic officials tout these statistics as progress, it only means that prices are still rising, just slightly more slowly than before, and very few prices (outside of gasoline and diesel prices) have gone down at all in the past three years. Thus, the prices of food, insurance, housing, etc. continue to be frustratingly high for a large number of Americans, and these high prices are also putting pressure on consumer finances, causing a slowing of consumer spending. As inflation has come down, interest rates have come down from their highs as markets anticipate easier Fed policy and lower interest rates. Housing, so dependent on mortgage rates, especially for first-time home buyers, has cooled slightly, but falling mortgage rates have kept a floor on house prices as competition heats up among the most affordable housing options.

Thus, the US economy is still growing, at a much reduced pace, helped along by large projects but slowed somewhat by increasingly tapped-out consumers. Prices have stayed high, and wages have barely been able to keep up, but people have just barely made do.

Further, we think the Biden Administration will try to spend as much money as possible to support the new Democratic candidate for President, Kamala Harris, especially since September is the end of the US Government's fiscal year, and all departments will be encouraged to spend their entire budgets, since it is feared a Trump victory In November could cause those budgets to be cut. All-in-all, we think the time before the election will show some of the largest monthly deficit spending in US history.

European economies are in similar straits – continuing to grow, albeit slowly, with hopes for ECB rate cuts providing some support for financial markets. Germany recently emerged from recession, helped by lower energy prices. But political uncertainty exists in France, as recent elections produced a more fractious and fragile government coalition which as not given much comfort to French markets, hurting economic growth.

Japan's economy seems to be continuing to grow, to the point that the Bank of Japan has still barely moved interest rates, despite a decades-low in the yen. This weak yen policy has definitely helped the Japanese economy, which thrives on value-added exports. Meanwhile, Chinese economic growth has continued its malaise by growing slower than its 5% GDP growth goal. Consequently, there is

growing pressure to keep China's yuan weak to compete against Japan's weak-yen export prices. This competition has also hurt other Asian exporters, most notably South Korea, and Vietnam. Since these economies are all bolstered by exports, this competition has kept economic growth in each lower than expected.

China's Peoples Bank of China (PBOC) has recently resorted to finally decreasing interest rates slightly, hoping that this stimulates the economy a little and drops the yuan to be more competitive with Japan's yen, but does not rekindle inflation or capital flight, which has picked up in recent months as rumors of a Chinese devaluation of the yuan "all in one-fell-swoop" drives capital to more predictable overseas markets.

Bottom line: The US economy has exhibited some recessionary statistics but does not seem to have entered a slowdown overall. Europe, bolstered by relatively low energy prices (compared to the past couple of years), has kept some economic growth, while Japan has seen its economy improve, possibly somewhat at the expense of China and other Asian exporter competitors.

Equities

The AI universe has led the equity markets higher in 2024, especially during the second quarter, when the biggest of the big got even bigger, with Nvidia actually becoming the largest stock in history for at least a couple of days, eclipsing Microsoft and Apple for a short time. However, the continued easing of inflation has convinced much of the US equity world that the Fed will cut interest rates, starting sometime in the third quarter (in fact, odds for a September rate cut are over 90% at this time). Recent inflation reports showing the inflation rate continuing to drop have also encouraged stock buyers to start to buy cyclical and smaller-cap stocks, thought to benefit more from falling interest rates. In fact on July 11th, when the most recent CPI report was released, small cap stocks staged their greatest rise (3.26%) versus the S&P 500 (-0.90%) in a day since October 2008, showing buyers are starting to consider small cap stocks after favoring mega-cap stocks for the last 20 months.

At this time, small cap stocks and value stocks have continued to reclaim some of the ground lost to large cap technology stocks in the last eighteen months, broadening the 2024 rally and giving some health back to the US financial markets, which had stumbled from all-time highs in the past few weeks.

It is still an open question about whether the broad stock market can build off this broad advance or whether it is mostly short covering from funds that had the "long large cap tech, short small cap value" trade on for years, which had been very lucrative. If the Fed continues to cut rates, small cap companies are usually able to take advantage of low rates and lower costs, so their stocks have the ability to be re-rated by the markets if lower interest rates persist. But the jury is still out.

However, the technology sectors of the stock market continues to dominate the market indices, as a few tech companies have gotten so large that their market cap-weighted movements overwhelm all but those of the largest companies in other sectors or large "factor" moves, like the one we've seen shifting from Large Cap Growth to Small Cap Value mentioned above.

The prospects for large cap tech stocks continue to be thought so compelling that estimates for those few large companies have skewed the whole stock market away from the aggregate estimates / statistics of the majority of the companies in large US stock indices. One example of this is the tweet

below from Jesse Felder, a respected financial pundit and analyst, which includes of a graph from the July 11 version of The Daily Shot daily financial email that shows that the S&P's next twelve months (NTM) price/earnings ratio has completely diverged from economic conditions, as represented here by the Bloomberg Economic Surprise Index. The US economy has registered a number of negative economic surprises lately, but the expected recurring earnings from these big tech stocks has kept the P/E ratio for the entire S&P 500 very high. We are worried that the economic surprises may continue to accumulate, pulling down the P/E ratios' earnings that could then pull down prices. Again – the jury is still out.

Jesse Felder
@jessefelder

'The stock market is overlooking signs of a softening US economy.'
thedailyshot.com/2024/07/11/rec... via @SoberLook

S&P 500 P/E Ratio and Bloomberg Economic Surprise Index

■ S&P 500 NTM P/E (L1)
■ Bloomberg Economic Surprise Index (R1)

24.0 / 22.0 / 21.8 / 20.0 / 18.0 / 16.0 / 14.0

1.00 / 0.80 / 0.60 / 0.40 / 0.20 / 0.00 / -0.20 / -0.40 / -0.62

2018 / 2019 / 2020 / 2021 / 2022 / 2023 / 2024

The Daily Shot

Source: Bloomberg

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Meanwhile, we believe that the Fed will lower interest rates probably twice this year, most probably starting in September, and we have kept our clients nearly fully invested, although in sectors we think

will lead the market but have much cheaper valuations than the mega-cap stocks favored by many in the markets today. In addition, we believe most investors see lower rates as a green-light for diversifying into more sectors of the S&P 500, although history says that the Fed lowering rates means they see real weakness in the economy. A weak economy/start of a recession (possibly) would be detrimental to the stock market, in spite of increasing liquidity and looser financial conditions caused by lower rates.

One other key to the direction of stock prices is earnings. Earnings held up reasonably well in the first quarter, but second quarter earnings are just now being released, and so far, some are disappointing. The Magnificent 7 and other mega-cap stocks will report in mid-to-late July, and we think the reception of these earnings reports will determine the direction of the market for the next few months (until the election and the ramifications of it). We are worried the expectations are so high for most of these large companies, and there is definitely the ability to disappoint. Nvidia and other direct recipients of AI spending could show very good earnings for quarters to come (due to their large order backlogs), but the markets' direction could be determined by those mega-cap tech companies spending the money on AI, which may be realizing far less revenue from their massive AI spend than investors are comfortable with, which could cause further selling.

International stocks are still a mixed bag: European stocks have risen for much of 2024 on the expectations of ECB (and Fed) rate cuts, with the general feeling that lower interest rates will help European corporates better compete with their US competition. The ECB seems teed up to start easing in earnest as soon as the Fed starts, or indicates when it will start – we believe we are there, and the ECB will cut interest rates at their next meeting, causing at least a further short-term rally in European stocks. We have been more cautious on European stocks because of their continuing weak internal economic growth, growing vulnerability to higher energy prices and the ongoing political turmoil caused by left-leaning governments trying to deal with large issues as diverse as the Russia-Ukraine war, climate change agenda versus economic realities, and continued large deficit spending that could start to tax government finances due to higher and higher interest expense in European government budgets. Projected lower interest rates aren't an attractive enough lure for us because we think they are justified by weakening economies, which will hurt equities more than we think the tailwind of lower interest rates will help them.

Japanese stocks have been rallying on better expected corporate profits and anticipated stronger growth in GDP as deflation fades and productivity soars. Meanwhile, the Bank of Japan cannot seem to raise interest rates, causing continued further downward pressure on the yen, which Japan's Ministry of Finance has had to intervene in favor of in order to keep the US dollar/yen from collapsing further. While we think Japanese corporations will continue to do better, we have only a limited exposure to Japanese stocks because we are unsure how the big fight over the direction of the yen will be resolved; once there is some resolution and the yen starts to trend, we will be much more interested in upping our exposure to Japanese stocks.

Chinese stocks have continued to do poorly, and their market is still by far the worst performing stock market among the largest industrial countries in the world. We continue to believe that Xi Zinping's Communist government continues to interfere in corporate decision-making, meaning a non-economic factor is a larger and larger determinant of what projects get done or built in China, increasingly divergent from the pure economics of those same projects. For us, that is suboptimal capital allocation, leading to underperformance and thus, our loss of confidence in investing in most business sectors of China. One we do like is the materials sector, and more specifically, the energy sector, in which some of our clients own oil companies. Otherwise, we continue to think many large Chinese

private corporations have become de facto SOEs (state owned enterprises) that act in concert with the government and at odds with its owners/shareholders by suboptimal capital allocation.

We still own Indian equities, which we believe will have a tailwind of at least 10 years as India builds out its industry and export capabilities, putting huge numbers of smart, cheaply-paid young Indians to work and reap the benefits of a huge domestic market and easier and easier access to it.

One final thought: US and world economic worries have led to corrections in the last few weeks to many natural resource and cyclical stocks as investors worry about economic weakness leading to worsening supply/demand fundamentals. As we will discuss in the Energy and Commodities sections below, we differentiate between resources we think will not suffer appreciably from lessening demand due to already tight supply/demand balances pre-slowdown and those which will suffer as economies slow more profoundly. We believe a number of energy, metals (both precious and some base) and some industrial companies will continue to benefit from current fundamentals and demand dynamics, despite some anticipated economic slowing. We think stock markets, used to evaluating growth stocks and using commodity-oriented companies as unlimited supply fonts, will better understand the difficulties of increasing supplies in an age of inflation, more difficult supply chains, geopolitical upset and political gamesmanship as economies slow and many prices don't fall with economic growth – reminiscent of the 1970s.

Bottom line: US interest rate cuts, expected by the market for the past 9 months, are providing a current tailwind for US stocks that we believe could end if the continued anticipated corporate profit growth does not materialize. However, favorable financial conditions and the promise of lower interest rates have so far trumped the higher inflation and economic upset being caused by inflation. We continue to favor stocks that can benefit from continued inflation and resource limitations, some of which include: oil companies, precious metal mining companies, metal fabricators, fertilizer companies, industrial miners and energy infrastructure stocks, including refiners. In addition, our clients own consumer staples and pharmaceutical stocks, things that will hold up in a recession but will continue to hopefully track the market during upturns.

Bonds

Bonds began the year in a continuing downtrend, as the Fed stayed on hold and a number of anticipated rate cuts were priced out of the bond markets. During the second quarter, bonds rebounded as weakening economic data and a skyrocketing equity market drove money back into fixed income.

So, what about now? High yield bonds, which have been trading as an equity market proxy for fixed income investors, are right around all-time highs, far outperforming all other "flavors" of bonds. Meanwhile, on a relative basis, US Government bonds continue to trade at a discount to historical levels in comparison to other US bonds, as investors continue to be concerned about large federal deficits regardless of the administration elected in late 2024. Those are the two ends of the spectrum – which one is "right"? Since we fall into the continued inflation camp, we believe that the cautious investors in government bonds are more correct in their pricing. Treasury auctions have been larger and larger in recent months to place all the debt to be rolled as well as the new debt, although auctions have been well received due to the upset and uncertainty in geopolitics worldwide and the relatively high value of other asset classes, particularly equities.

We believe with measured government-reported CPI inflation in the 2.9-3.1% range (meaning actual inflation is probably more in the 4-6% range), we don't see the reward in buying 10-year Treasury bonds that will only pay you nominally 4.20% over the next ten years, returning principal that may be only worth 70-80% of the purchasing power of your initial investment amount, much less lending for 30 years for just 4.45% per year for all those decades. We do understand that many will use it as a place to sit out other markets, but you still have to find a buyer for your position when you are ready to invest in something else. But "muscle memory" is ingrained in Wall Street, so the recent rally in fixed income is due to investors feeling more nervous about risk assets and thus moving some capital into "safer" fixed income, which is much less safe with inflation at 3+% than it was when it was when deflation was a bigger concern with inflation at 1-2%.

As mentioned above, high yield bonds are at or near all-time highs, mirroring equities; high yield investors don't see big problems on the horizon (even though business bankruptcies are the highest since the 2008 Financial Crisis). They may be emboldened by the Fed guaranteeing corporate debt during the pandemic panic of March 2020 – thinking that the Fed will have to protect holders if there is a systematic shock that sends most high yield bonds reeling. We think that is hopeful thinking over reality, so we have no interest in high yield.

Municipal bonds face the same fiscal worries as the federal government except they have a limit on how much they can borrow. So many states, cities and other municipally-financed entities are in tighter and tighter financial positions, and we think their tax advantages mask the risk behind potential financial problems (and possibly defaults) for many munis as inflation drives costs up faster than taxes can be raised or fees for toll roads, stadiums or other muni-financed projects can be ratcheted up.

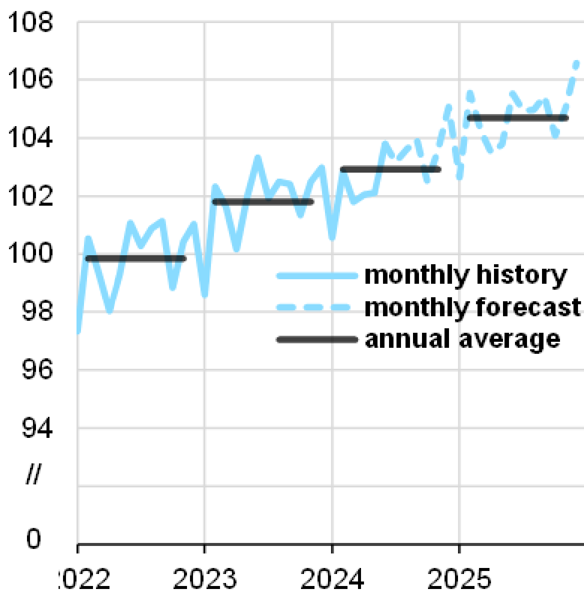
International bonds are really in the same straits, as economies struggle with worldwide inflation as well as weakening economies, at least in most large countries worldwide. European countries as well as Japan and China all seem to have bloated debt structures that seem vulnerable to us since they are currently accompanied by weakening economies and continued deficit spending meant to counter that weakness – not a good combination for bondholders.

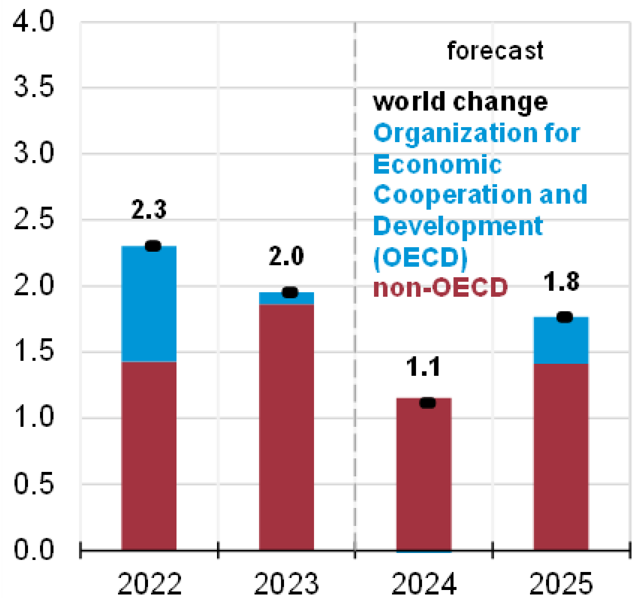
Bottom line: We think that bonds, while offering better yields than in recent years, don't present good risk/reward dynamics with inflation lurking, deficit spending continuing and sovereign debt levels at or above levels that have proven problematic to economies throughout history. We have customers with cash needs invested in short-term Treasuries, but the short-term is the only place we feel offers any value in fixed income. We believe the recent rally is from investors looking for risk-off assets and finding 4+% (nominal) returns in bonds, but we think that inflation and further deficit spending will make current rates unattractive in the near future.

Energy

Energy products prices were soft during the second quarter, as energy traders feared that weakening world economic activity would have a dampening effect on demand, leading to higher inventories and lower prices. However, this concern is not backed up by statistics: 1) world energy demand continues to set new records, while 2) supply, while currently plentiful, continues to grow more slowly than forecasted. In addition, the industry worldwide is not investing at a pace that is expected to grow production at a time of growing demand.

A number of organizations predict oil demand. In the following graph from the US Government's Energy Information Agency's (EIA) July 9, 2024 Short-Term Energy Outlook, world liquid fuels consumption is predicted to growth from approximately 104 million barrels per day in mid-2024 (blue solid line) to106+ million bbls/day by the end of 2025 (blue dotted line on the right side of the left-most graph). The average increase by year is illustrated in the right-most graph – it better shows that after two years of 2+ million bbls/day of growth (2022-23), growth will slow to 1.1 million bbls/day this year but accelerate to 1.8 million in 2025. While these numbers are averages for the year, historically the fourth quarter of the year is the maximum consumption time, so the industry should expect to supply more petroleum and products going forward (spring is usually the low usage point).





Data source: U.S. Energy Information Administration, Short-Term Energy Outlook, July 2024

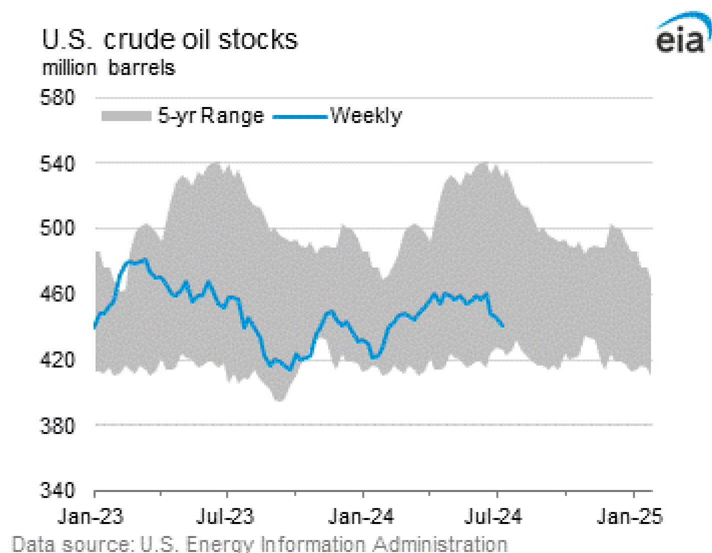
While these numbers are projections, they are consistent with many forecasts of current and future usage. The quasi-governmental organization which produces forecasts for the Organization for Economic Cooperation and Development (the OECD), which is one of the economic cooperatives which includes the richest ~40 countries in the world, is the International Energy Agency (the IEA). The IEA produces its own forecasts and in recent years has been more influenced by the spread of renewable technologies, and they have been predicting that demand for petroleum will peak in the next several years. Since they have a wide audience and are used by a large number of governmental agencies around the world, a large amount of the financial world follows their work and incorporates their (reduced) petroleum usage forecasts into government and corporate usage forecasts. Since historical numbers and current renewables usage numbers don't credibly back that a demand peak could be imminent, we think it's a mistake to follow these numbers, preferring more accurate forecasters.

Crude oil supplies are in the spotlight, with US Permian Basin supply growth still expected to lead non-OPEC+ production gains during 2024, along with higher output from ExxonMobil's growing Guyana production. Meanwhile, OPEC+ has continued their recent production ceilings for members, including Russia, to keep prices at relatively high levels – in which they've succeeded. As of this

writing, West Texas Intermediate (WTI) crude oil is trading at $84/barrel (with Brent slightly higher), indicating a relative shortage of worldwide crude supplies, in spite of the incentive to cheat on quotas/ceilings by OPEC+ members (and thus meaning there isn't much surplus for countries to use to cheat on their quotas).

According to industry guru Michael Rothman at Cornerstone Analytics, the oil industry continues its under-investment in exploration & production that first occurred in 2014, after oil dropped sharply from over $100/bbl. Since then, investors have insisted Western oil companies concentrate on financial discipline, paying much of their free cash flow to investors and only cautiously expanding exploration, meaning that much of the industry's "inventory," typically represented as "Drilled [but] Uncompleted" wells, known as "DUCs," has been completed and put into production, raising current production levels but cutting down on the industry's inventory of easily-brought-on supplies. This practice of using DUCs has masked the slowing growth of US shale, the engine of crude oil growth worldwide for the last several years. Rothman thinks the aggregate amount of capital not invested in new supplies since 2014 is approaching $1 trillion worldwide. And a tighter supply/demand balance means inventories have been drawn from storage lately, in spite of price weakness on anticipated slower demand, as shown in the following chart from the US EIA in their latest Weekly Energy Report:

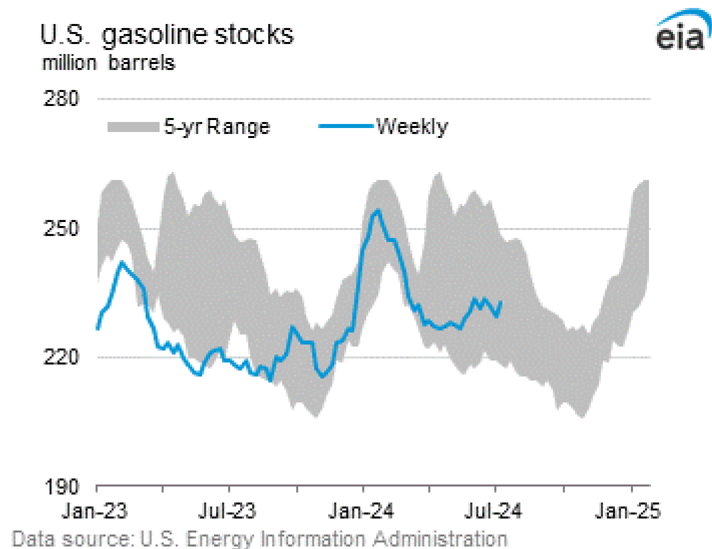
In the below graph, the gray area represents the rolling highest and lowest levels of inventory recorded over the last five years for each week. The blue line represents the latest weekly level of inventories. So as you can see, crude oil inventories usually build during the spring, leveling out in June-July, and start to gradually be used up in the fall and winter (the highest usage time of the year), when inventories generally are drawn to their lowest yearly level. In 2024, US crude oil inventories plateaued earlier and at a much lower level than 2023 or the indicated 5-year range, and have fallen for the last 3-4 weeks to levels not seen since February, a worrisome lack of buffer if geopolitical events rekindle and hurt worldwide oil production, meaning more demand for stable US crude production. This is bullish for crude, and we feel that this less recognized tighter supply/demand balance will be reflected in the near future in higher crude oil prices and thus higher exploration and production company stock prices.



Formerly larger producers have found it hard to even maintain production as inflation in energy services has kept many poorer countries from performing routine maintenance. Nigeria heads this list

of former larger producers with much lower current production levels (32 year lows, down below 1.5 million barrels yearly), but also on the list are Angola, Venezuela, Gabon, and Equatorial Guinea.

Refined products, specifically gasoline, diesel and jet fuel, have been in relative bear markets in recent months as traders have anticipated demand slowdowns, especially in the US. As we referenced above, the actual supply/demand statistics seem to belie these beliefs, as jet fuel usage has hit all-time highs this summer, buoyed by US consumers continuing to travel extensively. In addition, gasoline usage, which had slumped from last year's level earlier in the year, has picked up during the summer. Thus, we still think that exploration and production companies are making good money on their crude production, and we believe refiners, which have corrected during the second quarter, are recovering as utilization ramps strongly on summer fuel demand. The EIA gasoline inventory reported weekly shows inventories in the lower one-third of typical seasonal levels, showing supply/demand is tighter than market prices are indicating. We own refining companies and think that they will continue to perform well as demand for refined products holds up, defying the currently vocal critics.



Natural gas has continued to be the weakest of the energy products, as two mild winters and booming Permian oil production have combined to leave a surplus of natural gas available domestically. However, insatiable LNG demand internationally and the completion of a number of new LNG export terminals on the US Gulf Coast in the next few weeks/months should help build demand for natural gas, meaning we may have seen the bottom in natgas prices already for the year.

KANOS
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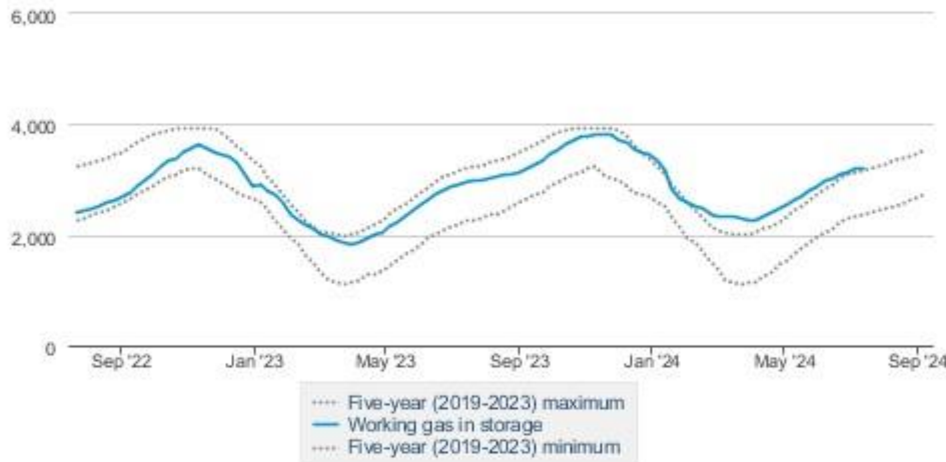
Working natural gas in underground storage

billion cubic feet



Data source: U.S. Energy Information Administration Form EIA-912, *Weekly Underground Natural Gas Storage Report*

In the above weekly EIA natgas graph of inventories, the blue line indicates the weekly levels, bounded by the five year maximum for the week as the top dotted line, with the 5-yr minimum as the lower dotted line. On the far left side of the graph, you can see 2022 levels were at or establishing the minimum 5-year inventory levels. As the 2022-23 and 2023-24 winters were very mild, inventories were not used as quickly, and the blue line defines the 5-year maximum inventory in both springs of 2023 and 2024. However, even with this extreme deviation in demand, inventories were under the five year maximums throughout 2023, and they have moved back inside the 5-year maximum recently in 2024. We think this subtly shows that natgas supplies are tighter than most think, and that the recent low prices will not be maintained as both US domestic demand and growing international demand through LNG exports will tighten supplies more quickly than almost anyone can register, driving prices back up into the high-single digit dollars per MMBtu within 6-18 months.

Bottom line: Perceptions of waning demand hurt energy prices during the second quarter, but over the last few weeks, the arrival of strong summer demand, especially for jet fuel, has recently boosted prices of crude and products. Crude inventories have been falling, indicating continued demand, while the use of DUCs to boost current production points to possible supply challenges in the near future. Weak natgas prices show signs of a tightening supply/demand mix not seen in two years. We continue to be bullish on most facets of the energy supply chain: exploration and production, pipelines, refiners and natgas producers. And as energy stocks represent a very low 3.6% of S&P 500 market capitalization, energy stocks are the best bargain in the stock market. In the 1970s, energy stocks represented between 15-35% of US market cap. More recently, at the 1999 bottom in oil prices, energy stocks fell to 6% of S&P market cap. By 2008, energy prices had moved up to $144/bbl, and energy stocks rose to represent 15% of S&P market cap. Today, with WTI crude at $80 and geopolitical upsets involving energy in both Ukraine and the Middle East, energy still only represents 3.6% of S&P market cap – we think far too low for the influence energy prices will have on the US economy and the results of the energy companies we own.

Currencies

Currencies have become important than in past quarters. First in the conversation of currencies is invariably the Japanese yen, which continues to be weak (surprise, surprise – it's been the weak sister in currencies for decades), but in this case, it broke to 40-year lows above 161 yen/dollar, as the Bank of Japan continues to resist further rate hikes, making the interest rate differential to other countries, especially the United States, less and less attractive, leading to further weakness and 40-year lows. However, a number of analysts are convinced that the relative healthiness of the Japanese economy, coupled with impending rate cuts in the US and Europe (and other western economies), and combined with Japan's Ministry of Finance's "war chest" for intervening in currency markets, will mean the yen has hit its lows and will start to appreciate from current levels. In our experience, currencies tend to trend for extended periods, but calling the turns in these trends is very difficult. Japan's Ministry of Finance has intervened a couple of times lately, driving the yen/dollar down to the 154 range, but no one is sure of how long they can intervene, and if shorts will pile on at some point again. Thus, we are not currently invested in either side of the yen/dollar trade. Although we are attracted to the period of yen depreciation, we respect that if the yen turns, the huge short position could cause rapid appreciation and losses for decades of built-up short-yen holders. Also, with no concrete evidence that the yen depreciation is over, it is hard to be long. So we wait.

The euro has also been chronically weak in recent years, but the ECB's reticence at easing too much before the US Fed starts easing, combined with European politics which have provided a little support for the euro recently, means that, in our minds, there is no attractive risk/reward in a euro position either way, so we are on the sidelines.

The other weak currency is the Chinese renminbi or yuan. As the Chinese economy struggles to grow amid its falling real estate market, "soggy" domestic demand growth and slow growth of their massive export economy, Chinese have been selling their yuan and buying substitutes, including gold and cryptocurrencies. With no easy way to express an investment in yuan directly, we continue to invest instead in one of their main substitutes – precious metals.

Mexico had their presidential elections (held every six years) during the second quarter, and Claudia Sheinbaum, the socialist former mayor of Mexico City and former President Lopez-Obrador's protégé, was elected in a landslide. Since she's a hardcore socialist, foreign investors in Mexico are wary of her future policies, and many speculators betting on Mexico's continued 'economic miracle' (of being the most attractive "friend-shoring" candidate for industries returning to North American strategically to benefit the United States needs) dumped their Mexican peso positions, driving down the currency in anticipation of less investor-friendly initiatives from the Sheinbaum government. While we think President-elect Sheinbaum's policies will be less investor-friendly than past presidents', we also think that the attractiveness of Northern Mexico's location and workforce, coupled with the need to keep the Mexican populace employed and happy, will mean that Mexican friend-shoring will continue in the future, and Mexican government interference, while probably more invasive, will be accommodated by industry as more industries are moved back from China. In spite of this analysis, we don't see the Mexican peso as an attractive buy at these levels, so we will stay on the sidelines unless the peso/dollar price drops further. However, we will still look at non-currency investments in Mexico, since a lower peso means higher profits for Mexico-based exporters of all types.

With weakness seeping through so many major currencies, the US dollar was stronger during the second quarter, but as we anticipate the Fed starting their easing cycle during the third quarter of

2024, we believe the US dollar will tend to be less buoyed by interest rate differentials which have held it up at the 103-104 level for many months, despite investors anticipating a US economic slowdown. Thus, we are not investing either way in directed-US dollar investments.

Bottom line: Currencies, while in the economic headlines, are mostly in flux currently, and we don't think current levels and the dynamics of each market point toward attractive risk/return situations in any currency at this time.

Commodities

The Fed's continuing to hold off on "promised" interest rate cuts have kept the US dollar relatively high during the summer, keeping dollar-denominated assets like commodities expensive around the world, curbing demand. Supplies of many different commodities have been plentiful, due in part to warmer weather worldwide which was beneficial for growing seasons and mining operations. In addition, slow growth economies in Asia have not demanded additional supplies, as forecast for the past couple of years. All these factors translate into nearly across-the-board weakness in commodity prices during June and July.

Precious metals have been the sole commodities continuing to perform well, as inflation combines with central banks' rhetoric swinging back to being more accommodative have continued to push investors to stores of value. Gold hit an all-time high of $2,488 in mid-July, although silver, platinum and other metals were not as strong and did not hit highs. Central bank buying continues to underpin gold prices, even as China announced no new purchases for the past two months. Chinese citizenry buying also has contributed to continued gold strength, as their continued poor economy and the threat of Chinese yuan devaluation (as happened in 2015) pushes people to diversify their wealth into better stores of value, especially gold (and Bitcoin, although it's illegal to buy and sell in China). In addition, India's recent economic surge has led to growing demand for gold in India, traditionally one of the best gold markets year-in and year-out. The economy is booming to the point that the Indian government lowered tax duties on gold imports by 60% recently, helping demand – we believe they did this to try to cap inflation for consumer goods, which are scarce as more Indians demand a higher lifestyle.

Agricultural commodities have had a banner year for supplies, driving down prices to multi-year lows after prices of wheat, corn and soybeans had been elevated due to concerns of supplies possibly affected by the Ukraine-Russia War. Supplies have not been appreciably affected, despite widespread fighting there and naval attacks by both sides. Brazil, a major supplier, has seen plentiful supplies, putting further pressure on prices. The only agricultural commodities showing strength are those affected by drought and supply problems, namely cocoa and coffee, both of which continue to have supply problems, and thus elevated prices. We believe that China, the traditional swing buyer, had built up supplies in the past few years, fearing shortages. Now, we believe they are using those inventories to try to limit the amount of imports and limit any further pressure on the yuan to which international purchases would contribute.

Base metals, led by copper, have had a good year, but plentiful supplies, lack of any upset from Russian sources and less real estate demand from sputtering Asian economies have pushed the supply/demand balance in favor of buyers, pushing down prices from their earlier highs in 2024. We still believe the Infrastructure, Semiconductor and Green New Deal/Inflation Reduction Act stimulus

programs will continue to put very large numbers of new infrastructure systems and all the metals needed in them to work for months and probably years, requiring heretofore unheard of amounts of copper, nickel, steel and other metals in electrification as well as facilities. So, we think the increase in usage and the supply/demand balance needed to achieve anywhere close to the number proposed mean a multi-year bull market in these metals – however, the cyclical downturn due to lack of overseas growth in demand has caused prices to correct and supplies to have to adjust, at least in the short-term.

Interestingly, coal usage continues to grow apace, with almost no fanfare or criticism that we hear. The ever-greener International Energy Agency in their latest (July 2024) review of worldwide coal usage sees worldwide coal consumption increasing 1.0% during the first six months of 2024. And this is after coal consumption plunged 17% and 23% during 2023 in the United States and European Union, respectively. Meanwhile, Chinese coal production just hit a multi-year high as the Chinese depend on both domestic and imported supplies to keep up with their burgeoning power demands, met at the margin with new coal plants, as are the increasing power generation needs of India. With these large economies continuing to add capacity and usage continuing to grow, we continue to like US coal companies, with stable domestic cash flows and lots of export opportunities to Chinese, Indian and other Asian customers.

Bottom line: Commodities are undergoing a correction as interest rates, the US dollar and growth scares in Asian economies lead to Western investors selling some of their commodity positions. However, precious metals, specifically gold, and gold related investments, have bucked this trend, proving to a be attractive investments now and in the future. Other metals continue to have good fundamentals and huge future prospects, so we are willing to wait on performance in our silver, copper and other base metal investments. Agriculturals have proven to be much more resilient in supply, so fundamentals are not particularly favorable, and we have minimized our investments in these, although there are some that are still attractive. Finally, we think coal is an unstoppable juggernaut of cheap energy for developing economies, and we think US coal companies are well-positioned for supplying thermal coal for power generation around the world.

Kanos Quarterly Commentary 1

The Moment of Truth Approaches:
Is Inflation Over? Will the Fed Do the Right Thing?

We all have seen the playbook deployed now so many times – 1) Federal Reserve and US Government officials see a strong economy into the future, 2) as the economy weakens, the authorities continue to proclaim that there's no trouble on the horizon, in spite of faltering economic statistics and weakening corporate quarterly results, 3) economy weakens further, leading to stalling job growth and eventual aggregate job losses for the US economy, 4) US GDP is reported to be negative, indicating a shrinking US economy, 5) the Fed eventually responds by lowering interest rates, claiming that everything looked fine until a sudden downswing in economic activity, 6) In many cases, Congress and the President pass one or more fiscal stimulus packages to make sure the economy recovers

quickly, the combination of lower rates and fiscal stimulus helps the economy recover and reestablish a growth trajectory, and 7) the Fed is praised for "doing its job" and the Government takes credit for a "robust recovery" caused by great government fiscal program.

This has been the Greenspan-Bernanke-Yellen-Powell playbook since the early 1990s, coincident to the time that Western governments decided to allow corporations to globalize, altering tax and labor laws so that corporates were allowed to outsource operations to overseas factories, plants, and other industrial facilities. This was done so that labor costs could be cut substantially through third-world countries' far-less restrictive labor, zoning, and environmental laws and regulations. The success of Western companies moving operations to Central Europe and East Asia, eventually led to operations being moved even further down the wage-price chain to even cheaper labor pools in Southeast Asia, and even Africa, allowing companies to make larger and larger profits while still passing on some of the cost savings to consumers. The countries themselves got into the act, most notably China, putting their largely rural population to work in factories to make industrial and consumer goods at a fraction of the costs of manufacturing in OECD developed nations. Thus, (almost) everyone made more money and were better off: multinational corporations expanded operations, made more money and passed on some savings to consumers and businesses, which kept a lid on inflation. Governments expanded trade, power and taxes as corporations made more money. And consumers were helped by relatively stable prices and relatively low interest rates as central banks expanded money supply and kept prices in check with structural goods and overseas services deflation. It culminated in the late 2010s when the Fed bemoaned the fact that "inflation was too low – we cannot seem to generate enough of it, and don't want to have deflation" [which, in their minds, causes consumers to hold off purchasing, thus reducing economic growth, a central bankers nightmare]. Of course, the losers were the workers in developed countries – the G20 (twenty richest nations), whose workers had to add a lot of value and be very productive to be able to be paid multiples of similar workers overseas.

And this 1990s-2020 era survived one big commodities upturn in the mid-2000s, although some might say that episode was "cured" by: 1) the near destruction of the banking systems of the Western world in 2008 financial crisis, only rescued by an extreme amount of central bank liquidity, 2) continued growth in many overseas economies and, most importantly, 3) cheap energy prices in the 2010s due primarily to the rapid rise of US shale production and the supply shock it caused keeping energy prices reasonable for slower growth post-financial crisis. Non-partisan economists might also say that US inflation and economic growth was helped by Congressional Republicans who insisted on fiscal discipline, keeping US budget deficits at manageable levels.

But as economists like to say, there is no free lunch. The Greenspan model, still followed today, where recessionary issues are denied until the recession is in force, eventually making central bankers look like heroes (by "putting out the fires they fanned"); but, the Fed's lowering of interest rates always adds to inflationary forces and unfairly supplies easy money and liquidity to the largest entities in the economy, the least in need in times of stress. And governmental fiscal programs continue to be passed and implemented by new administrations despite their gigantic costs and questionable actual effect on economic growth, and also contribute additional inflationary forces while providing questionable benefits.

Finally, the pandemic, which resulted in lockdowns followed by a gargantuan monetary + fiscal stimulus "bazooka" and then by three more fiscal programs by the Biden Administration, including infrastructure and large new green energy initiatives caused inflationary forces to rise significantly. Add in that the lockdowns disrupted world trade and thus the long cost-determined supply chains formed solely for economic reasons, resulting in more inflationary forces. The final ingredient was

geopolitical, where the eruption of the war in Ukraine, polarizing the political and economic world against Russia, the largest source of natural resources on earth, changed the landscape even further.

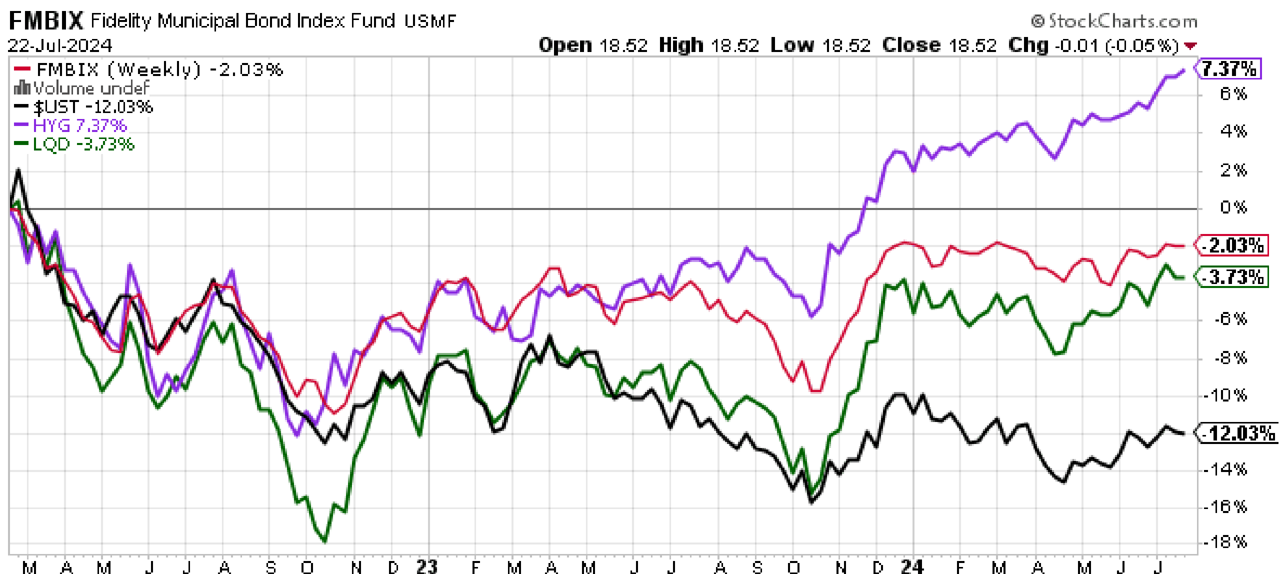
The result? The measured Bureau of Labor Statistics 12-month inflation rate, which had varied around the 2.0% level since 2010 and had fallen to 0.1% during the pandemic, screamed higher to 9.1% in June 2022, easing down to the 3.1-3.4% rate over the last five months, as energy prices, spiking during the beginning of the Russia-Ukraine War, roared higher in early 2022 but backed off over the next couple of years as supplies weren't interrupted from Russia to markets in Europe and Asia.

Now, with energy prices settled into a range, industrial metals prices off their highs, agricultural / food / fertilizer commodities at multi-year lows and wage growth barely keeping up with inflation, prices are still advancing at a 3.0% (annual) rate.

Even with this imbedded higher inflation, US Government spending has continued at an elevated pace, further contributing to the inflation problem through massive multi-year stimulus programs and expanded foreign aid for overseas combatants, Ukraine and Israel. This has led to yearly budget deficits on the order of World War II spending, even more percentage-wise than the Vietnam War + "Guns and Butter" spending by President Lyndon Johnson's Administration during the mid-to-late 1960s.

And the US bond market has noticed! The size of US Government bond auctions has grown and grown to the point that pundits are worried about whether there will be a failed auction in which not enough buyers are found for these Treasuries. Traditional buyers like China, Japan and Saudi Arabia have not been net buyers of Treasuries in a while, and Russia has divested itself of its formerly large Treasury portfolio. Europe, Latin America and the rest of Asia have had to supplement US and Caymans (offshore hedge funds) bond buying, so far with no extreme weakness or faltering auctions.

But looking at the different "flavors" of bonds shows how this supply has hurt the recent performance of Treasuries. In the following StockCharts.com graph, the performance of the 10-year Treasuries (the black line) is graphed against High Yield bonds (the purple line), municipal bonds (the red line) and investment grade corporate bonds (the green line) over the last 2+ years:



The 10-yr Treasuries have clearly underperformed, most probably due to the extreme amounts forced into the market by Treasury. What will happen if not enough buyers show up? The obvious answer is that the Federal Reserve will step in and buy the rest of the issue. But that is de facto quantitative easing (QE) – the equivalent of lowering interest rates, into an "above the prior range" inflationary environment. This will almost certainly goose inflationary forces in the economy and world financial markets.

The equivalent reaction could happen if the US economy sinks under the weight of heavier and heavier debt and slows down past "stall speed," resulting in a recession. The Greenspan et al formula of lowering interest rates to stimulate the economy could result in a lot of inflation before the stimulus boosts the economy, exacerbating the economic weakness and driving the economy further into recession, like in the 1970s.

In this environment, if the Fed lowers interest rates, or if that doesn't work, resorts to QE to buy Treasuries, there is a chance that "the bond market takes away the printing press," the Fed's actual worst nightmare. In this scenario, lower interest rates or QE results in higher long-term rates. This reaction is when bond holders believe the Fed is contributing to the inflation problem instead of trying to solve it – in aggregate, the bond market sells as many bonds to the Fed as they will buy, leaving other buyers to bid even lower prices (and thus higher yields) for bonds still in the market.

If this sounds like Armageddon, the Fed thinks it's so, too. However, it is not so far-fetched. Famously, in their book "This Time is Different," Carmen Reinhart and Ken Rogoff, Harvard economists, studied high debt economies. They surmised that after looking at hundreds of years of high-debt economies, the ability to heal from such a condition gets very much harder if the government's debt exceeds 90% of the GDP of the nation. Unfortunately, the US Government has borrowed so much that US Government debt-to-GDP has risen from 39.5% in 1970 to 123.7% in 2024, according to Lacy Hunt, Hoisington Asset Management in their Quarterly Review and Outlook, Second Quarter 2024.

Truly the Moment of Truth approaches – will the US Government be able to continue to spend at an unsustainable rate? Will others continue to lend at "risk free rate" type of interest rates? Or will the disaster strike and an auction fail, forcing the Fed to buy? Finally, could the bond market actually take away the printing press? Reinhart, Rogoff and history say that it's inevitable unless the problem is tackled, and solutions are attempted.

Kanos Quarterly Commentary 2

An Effective Leader

Here at Kanos, we try to focus on the aspects of the world around us that will affect and possibly drive the investment world, and then we try to filter out those things that may be loud in our lives but have little effect on your investments.

In the spirit of this ethos, we think that the recent assassination attempt on presumptive Republican nominee and former president Donald Trump have presented large focus on him and his reputation and past that WILL affect business/regulatory policy, and thus, investments, if he is elected. Wall Street research has been full of articles since the June 27th debate about the new Trump Trade and reconfiguring portfolios for the coming Trump Presidency. One final reason to examine Trump more closely is the contrast in leadership and management styles to the current Biden Administration and leftist policies it is pursuing, which the presumptive Democratic opponent, Kamala Harris, has already said she would continue. With that, we present a thought-provoking article by Chris Irons, a financial blogger who runs a blogsite and interview site called Quote the Raven Fringe Finance, which often has insightful although sometimes incendiary opinions. This one seems worth your time.

Fearless

SUNDAY, JUL 14, 2024 - 07:10 AM

Submitted by QTR's Fringe Finance [Chris Irons' financial blogspot]

A couple of hours before the assassination attempt of President Donald Trump, I was sitting in a bar having a laugh with some new friends I had just met from Texas.

Our discussion was centered around how divided the country has become and why we all felt another four years of President Biden would be an unmitigated disaster.

In the spirit of honest discourse among new friends, we began to rattle off the things we liked and didn't like about Trump, as well. We conceded to each other that Trump was vain and a narcissist, obsessed with his own image, but we also agreed his policy stances would be far better for the country than those of the Democratic Party.

And the self-obsessed narcissism criticism you, and everybody else, should know by now: it's been lobbed at Trump for so many decades now he probably takes it as a compliment.

Look, I'm a realist. I understand that it's easy to look at Trump's personal life and career prior to being President and conclude he's always prioritized the money and the image over substance.

From Trump Airlines to Trump Steaks to Trump University to Trump's namesake casinos in Atlantic City, combined with allegations of not paying vendors that worked for him on projects and fabricating positive press about himself in the media, I don't fault people for taking that view of the man.

We could sit here and analyze what drives Trump to engage in these patterns of behavior, which would probably take forever since it would require him to undergo a trillion hours of therapy to uncover his deepest trauma, or we could zoom out, take a 30,000-foot view and simply take note: for one reason or another, the f*cking guy is driven.

And it's this incessant, relentless, fearless drive and desire to win — no matter what is fueling it — that has allowed Trump to shake off his past business failures and eventually land on The Apprentice, which became a resounding success. It's the same drive that empowered Trump to campaign obsessively in 2016 and then defy all odds to win the presidency.

People first joked that Trump was running in 2016 as a PR stunt. Maybe he was. But at the end of the day, he manifested himself into the White House. And, to boot, he did a decent job: he ran the country effectively, slashed regulations, cut taxes, kept us out of war, and kept the economy booming.

Regardless of why he wanted to become president, once he was put in that position, he did a decent job of "getting shit done" and won the respect of many world leaders who otherwise wouldn't have taken him, or the United States under a President Hillary Clinton, seriously.

As I was saying to my new friends last night, his style is brash and he is cutthroat as a businessman. He's the personification of the Wall Street shark who, in business, gets a reputation for screwing the little guy. But if you're not his counterparty and he's negotiating on your behalf (or your country's behalf) isn't that exactly what you want? Someone who will fight tooth and nail, to the death to win, and who refuses to be intimidated? If Trump is striking a deal that'll benefit the country, does it matter to you that it's his ego driving his bold nature?

Putting aside what drives him, the fact is simply that nobody needs to tell him to get out of bed in the morning. While campaigning, he often makes multiple stops in a day, and while he was president, he went to war with the press for hours at a time nearly every single day. Those are positive character traits for a President no matter what is fueling it. It's consistency, perseverance, reliability.

And last night, after surviving an assassination attempt, President Trump didn't hurriedly rush off the stage. Even after he was surrounded by multiple Secret Service agents, and it became evident that his life was in danger, he chose to stand on the stage and raise a fist in the air to show the world that the engine that drives him to push forward still hadn't shut down.

I said to another friend last night that Trump is such a PR genius that it's probably just muscle memory for him to seize momentous occasions as photo opportunities.

Anybody that has watched him publicly knows a lot of times he'll "pose" in the middle of saying certain sentences or during certain meetings because he knows a photograph of that image will capture the brand that he wants to sell to the world.

Think about this. When we watch the UFC, do we care about what's going on in the personal lives of the fighters outside the octagon? Do we spend time bemoaning how some fighters, like Nate Diaz, for example, are simply just "built different" and love to fight for the hell of fighting? No, we sit back and watch them take personal pain and obsession and turn it into remarkable careers. Then, we celebrate them.

At this point in Trump's life, he has gone far past being a caricature of himself and has simply believed and manifested himself into being a success by being "built different". You can call it ego and narcissism if you'd like, and it probably is, but, as is the case with most all of us, Trump's personality disorders are the gasoline that he uses to fuel his engine.

So we can talk about Stormy Daniels, or we can talk about taking on irresponsible amounts of debt to fund the Taj Mahal [Hotel & Casino]. We can talk about Trump's obsession with his image or how he lies about golf scores and bullshitted his way to the top. But how can you argue the man isn't a success? He was President of the United States and one of the most well-known individuals on the face of the earth. How can you say he's a terrible family man when his children routinely show up to support him and he has been a provider for them his entire life? How can you say he's not courageous to stand down a litany of extremely damaging, false allegations throughout his entire tenure as President?

And putting aside his motivation, how can you not say that choosing to stand on stage after being shot instead of ducking, hiding and scurrying away isn't courageous?

At the end of the day, I don't care what drives him. Trump is a guy that perseveres.

And if you view the country like I do right now, as a scattered, disorganized free-for-all, badly losing its grip on both law and order and its moral compass, a little drive, direction, perseverance and courageousness could go a long way for us.

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