KANOS
CAPITAL MANAGEMENT, LLC

Kanos Capital Management

Quarterly Investor Letter

Third Quarter 2024

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Third Quarter Market Review

The major development during the third quarter was the anticipation of and the Federal Reserve's decision to cut interest rates, the first rate cut since the pandemic. It came as the Fed shifted its focus to unemployment as it judged inflation to be in check. Most financial markets advanced during the quarter, interrupted by two downdrafts, one caused by the Japanese interest rate change and one caused by an early September growth scare. Equity markets put those episodes behind them, with the Dow Jones Industrial Average finishing the quarter at 42,330.15, having set new all-time highs during late September. Ditto the S&P 500, which closed at 5,762.48, up 5.5% and just a fraction off an all-time high set September 26th. The Nasdaq finished up for the quarter at 18,189.17, up +2.57%, approaching new all-time highs set in early July (all performance numbers reflect total returns). Most economic weakness was discounted as the Fed continued to convince many investors that a soft landing for the economy was in store. International markets for the most part kept up with US advances, with Europe's STOXX advancing 2.93% and India advancing 6.66% while Japan dropped -4.20%. China's financial markets were jolted with economic stimulus measures the last week of September, pushing Chinese equity markets skyward after months of underperformance, with the Shanghai Composite gaining back all of its quarterly losses and ending +12.44%.

Looking Forward

Introduction

Projecting forward, we see financial markets continuing to be bid upward due to continued government spending, more-than-ample liquidity provided by central bank liquidity / further easing and corporate buybacks. Slowing economic growth in Western industrial companies has been met with initial forays of lowered interest rates by G7 central banks with more seemingly on tap, leading to buoyed bond markets and a scramble for yield by large asset managers worldwide, making both sovereign and corporate debt issuance easy for the time being.

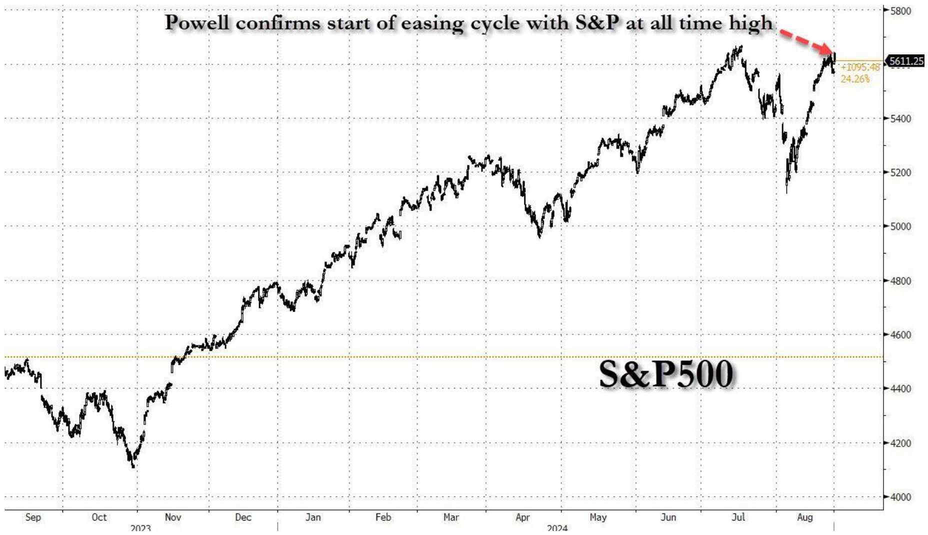
As we've highlighted in many past letters, we believe inflation will continue to be an issue for the world, US economy and US consumers. US Fed Chair Jerome Powell in his August 23rd speech at the Fed's Jackson Hole symposium signaled the beginning of a Fed rate cut cycle. We believe it will contribute to a new period of inflation, and a recent article sums up our thoughts well. Titled "Powell Vows To Cut Rates With Stocks, Home Prices, Rents And Food At All Time Highs," at Zerohedge.com on 8/23/2024, the salient passages include:

> "[After Powell's Jackson Hole speech this morning, putting] inflation fully in the rearview mirror, the "Powell payrolls pivot" is now complete because as the Fed chair said, 'the cooling in labor market conditions is unmistakable' ……. Or, as TradeStation head of strategy David Russell said, '*here comes the punchbowl. Jerome Powell came out swinging today with a litany of dovish signals. He said inflation is on a sustainable path lower and talked about how the job market has cooled to pre-pandemic levels. He drove the point home with a clear call*

for adjusting policy.' The market agreed, and quickly cemented at least one rate cut while also pricing in as much as 33% odds of a 50bps rate cut.

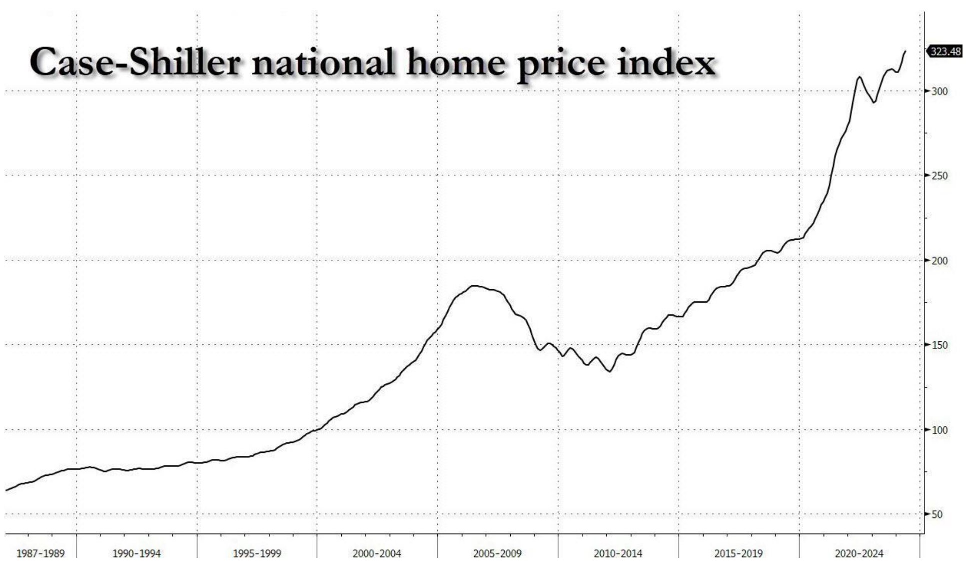
"There are just four ***small*** problems with this.

"First: the Fed will end its tightening cycle and starts the next easing cycle **with stocks at all time highs,** something that has **never before happened in the history of capital markets!**



"It means that, unless the current expansion ends in a gruesome recession which crushes the economy, the S&P is about to enter a full-blown bubble, which in turn will burst in even more spectacular fashion and force the Fed to not only cut back to ZIRP, but activate NIRP (just like Japan did years ago) and also go right back to QE and buying bonds ETFs. For now, however, as in the next three months ahead of the elections, all shall be well …..

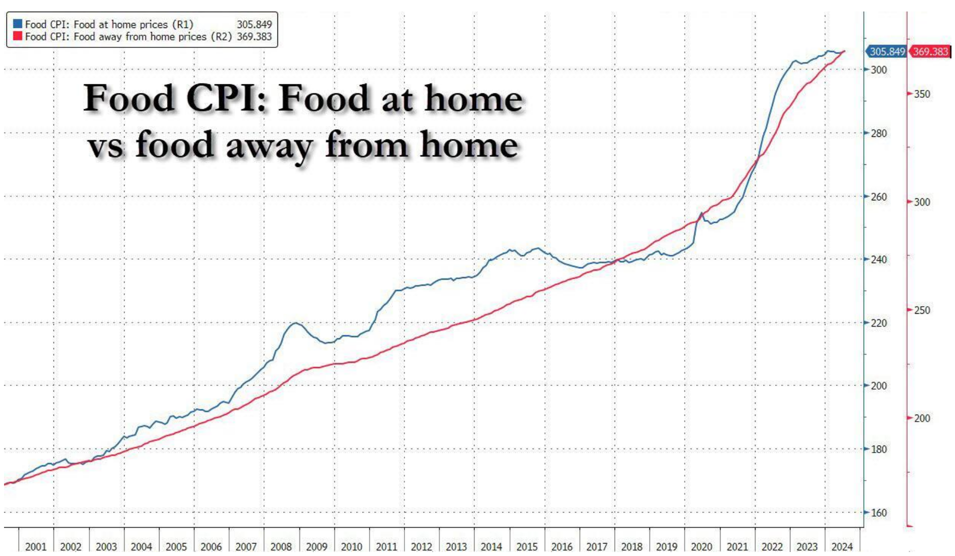
"Second, this is also the first time in history when the Fed has aborted a tightening cycle **having achieved zero home price easing.** Indeed, one look at the Case-Shiller [National Home Price] Index shows that home prices are the highest they have ever been...



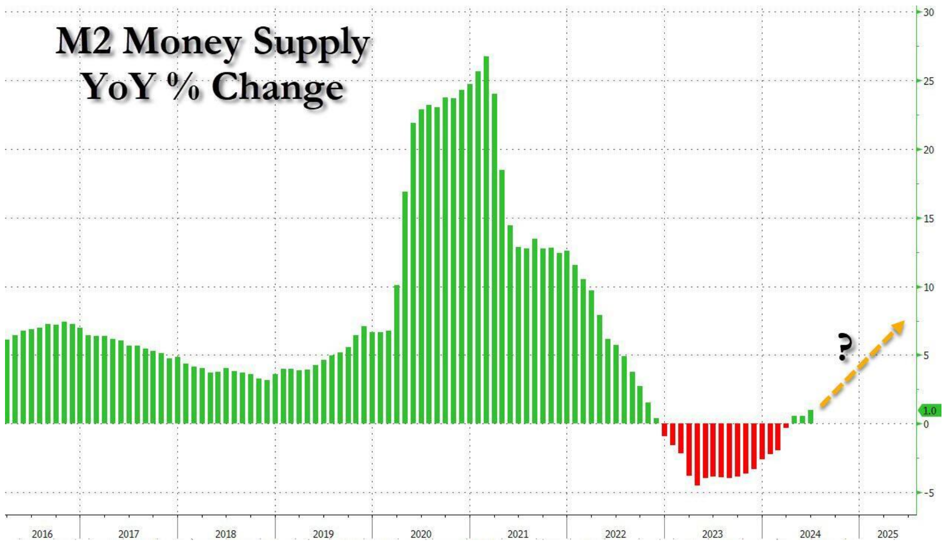
"... as are actual asking rents according to Zillow (not that delayed aberration known as Owner-Equivalent Rent).

"And then you have Kamala's promise to provide $25,000 in new home purchase subsidies, which will go straight to the asking price, sending prices even higher. In short, **both home prices and rents, already at record high, are about to go record-er...**

"Third, while one can technically live without housing or rent, one still needs to eat. And here we find another problem, because not only did the Fed's rate hikes not contain stock, home or rent prices, **but food prices - both at home and away from home - are also at all time high!** And guess what cutting rates and stimulating the economy will do to food prices from this point on...



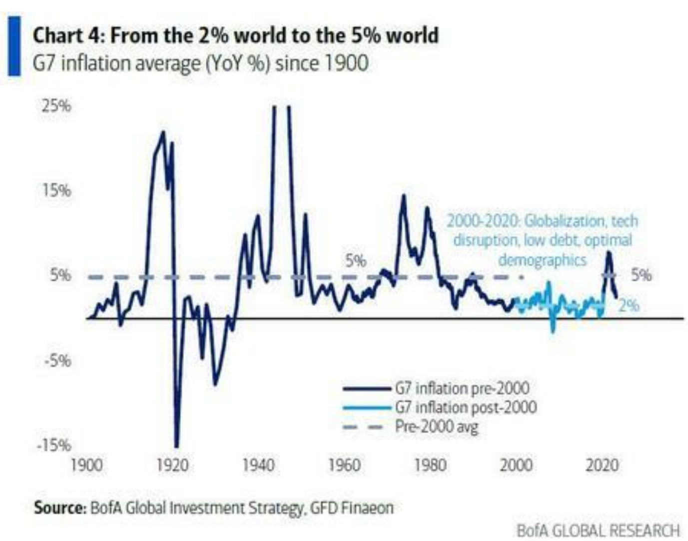
"Fourth, and final, the seeds of the next inflationary bubble are already set, because even as the Fed kept conditions tight (or even exceptionally tight), M2 - the broadest money aggregate tracked by the Fed - is once again rising after declining for the past three years.



> "Of course, there are countless other examples, because besides the above case studies, prices are at all-time highs pretty much everywhere else too. But you get the message. The only question is what can possibly go wrong with the Fed launching an easing (i.e., monetary stimulus) cycle with prices for pretty much everything, stocks and homes included, at all- time highs and rising."

While the article is written with a sarcastic bent, it takes on the quandary of the Fed – they are seeing employment starting to soften while inflation has continued to move down, thus (at least in Powell's rationale) allowing them to shift from emphasizing their 'stable prices' co-mandate (trying to moderate inflation) to their 'maximizing employment' co-mandate, at the expense of inflation fighting, we believe. This Powell Pivot is now justifying our emphasis on inflation and how to counter it in your portfolios, as we will discuss in detail below.

Why is this a problem? Well, as illustrated in the next chart from Michael Hartnett and Jared Woodard of Bank of America in the article, "Hartnett: The Commodity Bull Market is Just Getting Started" (Zerohedge on 9/2/2024), the 2% inflation world (for the G7 Western industrialized countries) only existed from about 2000 through 2020; before and since, these G7 countries, most notably the United States, has experienced more like a 5% inflation environment.



Powell et al at the Fed do not seem to have factored in the serial goods deflation that came from globalization and outsourced Chinese (and other countries') very cheap labor that occurred during a time of falling interest rates and optimized supply chains during the 2000-2020 time of maximum globalization. Today, many of those elements that kept costs down are missing: 1) interest rates are higher than those during much of the 2010s, 2) supply chains are messier and subject to national interests, geopolitical upsets and reshoring/friend-shoring (at much higher cost), and 3) higher cost structures (costs of services, labor and some products are at all-time highs) despite a lower rate of inflation, which is just the rate of increase in those costs, i.e. costs are still rising, but at a slower pace.

Economy

Many statistics illustrating the US economy continue to paint a picture of sustained growth, like the recently reported final second quarter US GDP of 3.0% and the Atlanta Fed's GDPNow coincident GDP reading of 3.2% as of mid-October. In addition, job additions have continued to climb, with weekly jobless claims staying at a low level for the past few months.

On the flip side, monthly purchasing manager surveys (PMIs) have consistently been showing little growth, with manufacturing surveys consistently indicating recessionary conditions for months while services are only growing at a slow pace. In addition, one of the measures built to predict recessions, the US Leading [Economic] Indicators index, has dropped every month but one since February 2022, showing consistent weakness in parts of the US economy. Finally, small business confidence has been at low levels for months, putting a damper in the traditionally most vibrant sector for job growth.

So, what's going on? We believe the economy essentially has two tracks going – an industrial, government-centric economic push sustained by huge technology capital expenditures by tech, government and large multinational firms. In addition, we have infrastructure and reshoring occurring throughout North America, adding to economic activity. At the same time, high consumer prices caused by high and still-present inflation have curbed economic activity for many less well-off consumers, leading to reduced spending and thus lower business activity for many smaller businesses as people barely make ends meet, since wages, albeit rising, have not kept pace with price rises/inflation, making it harder for low-end consumers. This bifurcated economy is obscured by the ease of collecting big company statistics and the difficulty of capturing small business / lower end consumer activity due to its scale. Thus, we think the economy overall is slowing, with conditions similar to a classic recession, although some big sectors are still growing, albeit slowly. A good illustration of this is the employment situation: lots of jobs have been created in the past couple of years; however, a large majority of them are part-time and low-paying, and many have been taken as second jobs by current jobholders, meaning the economic benefit of those jobs is very low – they are being used to make ends meet and don't represent more need for housing, for large purchases, for travel or any other typical economic effects of a new employee.

A more optimistic economic future will have to incorporate supply responses to the supply/demand imbalances which have led to and continue to lead to further inflation, albeit at a lower rate. Producing more (and thus hopefully cheaper) energy, materials, housing, cars and machinery, etc. will need to occur to keep a lid on prices and restore a balance to wages earned so consumers can once again have adequate purchasing power. Supply responses will generally benefit from 1) lower regulations, 2) less government involvement in business, and 3) more financial incentives (both tax and fiscal), etc. Only when human ingenuity and capitalism can combine again to produce what

Americans (and the rest of the world) want efficiently, productively and driven by supply and demand, will the economy get back in balance to make it more attractive to all US inhabitants.

Most European economies have softened, led by France, having a post-Olympics "hangover" and Germany, suffering once again with energy and labor issues. The European Central Bank (ECB) has eased interest rates and is assumed to do so again a few times into next year. With less of the technology spending seen in the US and Asia occurring in European economies, their growth is much more muted. We are not as attracted to European-centric businesses for this reason.

Japan's economy looked like it was ready to recover more strongly than it had in decades, allowing the Bank of Japan (BOJ) to embark on a hiking cycle (albeit very slowly). After its first hike earlier this year and more surprising second hike in July, the yen soared, upsetting world financial markets for a couple of days and hurting both the Japanese economy and Japan's Nikkei stock index. This has led to new Prime Minister Ishiba to meet with BOJ Governor Ueda and announcing that there would be no more rate hikes due to delicate financial conditions. Thus, the Japanese economy seems more vulnerable and sensitive than formerly thought, and we don't see it being a source of growth anytime soon, especially as Japanese companies are increasingly having to fight for market share with more desperate Chinese companies.

China's Peoples Bank of China (PBOC) coordinated with government authorities to launch both monetary and fiscal measures to try to revive growth in the world's second largest economy, which Xi and other governmental leaders saw as falling far below the reduced 5% target for growth this year. Growth has not been achieved because 1) Chinese consumption hasn't recovered its pre-Covid growth rate due to reduced consumer confidence, 2) the property market continues to suffer from oversupply, higher interest rates and lack of further consumer investment in speculative real estate ventures (after many suffered losses over the past couple of years), and 3) slower economic growth around the world, curtailing international demand for Chinese goods, which have been the big driver of Chinese economic growth for the last 2-3 decades. The new stimuli from the PBOC/government included lowered interest rates, lowered reserve ratios for banks, revocation of limits on multiple home ownership and lowered downpayment percentages, among other measures. These efforts lit a fire under financial players, with stock investors, both domestic and international, flooding the market with buy orders and seeing prices rise on average over 25% in two weeks ending September and beginning October. Can these measures shock the Chinese economy back into higher growth? History says no, that this is more like a "sugar high" that, absent any Chinese corporate buy-in and demonstrable Chinese domestic consumption figures rising strongly, will fade in the next few weeks. Sure enough, mid- to late-October Chinese stock market activity gave back more than half the earlier gains, as many more questions arose about how sustainable the gains really were. Further stimulus measures will almost certainly be needed (the market had already anticipated more, contributing to the recent retracing of the rally when little further stimuli arrived), and we will talk in further sections about how we might take advantage of this situation.

Bottom line: US economic statistics continued to show grow as technology capital spending combined with government sponsored infrastructure projects power growth in the "large company" sectors of the economy. We have concentrated our non-resource investments in many of these sectors, including defense, industrials, pharmaceuticals, and technology. We see these trends continuing, regardless of the election results in November, and plan to continue to be invested in a similar way as we see the US rebuilding infrastructure, the military and new technology for the next few years, at least. Meanwhile, we believe many US consumers are having trouble making ends meet, making the consumer side of the economy recession-like; thus, we are avoiding consumer-centric sectors like retail and consumer discretionary.

While we think an easy money Fed will lead to a lower US dollar over time, we're not that attracted to overseas investments right now, due to the lack of worldwide growth, highlighted by continued slowing growth in China, which seems to reverberate around the world these days. We still like resource companies around the world, but we are wary of governments with stretched budgets looking to mines and energy sources developed corporately as a source of extra funds, robbing shareholders of investments made years before.

Equities

US equities have continued to advance, and we have been nearly fully invested as we see the trends from earlier in the year continuing. Tech and AI led a strong advance in the late spring/summer, but since late July/August, many other sectors in the US stock market have advanced strongly, like industrially-oriented companies, which are beneficiaries of the new and refurbishing infrastructure initiatives, both corporate and governmental. We see these as having many more years of runway, as so many roads, bridges, wires, etc. are at or beyond their useful lives and will need to be replaced. We will continue to look for US companies with attractive growth prospects at reasonable valuations to add to or replace our current investments.

International stocks are in general at much more attractive valuations than their US counterparts, offset somewhat by investment analysts' estimates of more modest growth overseas currently. As mentioned above, we share these doubts about sustainable growth in many parts of the world. US corporate earnings growth continues to look more attractive than most of the rest of the world, especially with China failing to reach its 2024 goal of 5% GDP growth, and analysts wondering if they can even achieve 4%, which is taking its toll on industries tied to China's voracious appetite for raw materials of all types, especially energy. But as we look below the surface (see the Energy section below), we think that energy and materials usage, while not growing at earlier-forecasted levels, is still growing, tightening the supply/demand picture in energy and other materials more so than analysts believe, making many stocks in our portfolio poised for big gains when this tightness leads to more favorable pricing and economics in the near future.

Japanese stocks have rallied back from their swooning in July/August when the BOJ indicated they would be starting an interest rate hiking cycle. That has since been walked back by both BOJ and the new Japanese Prime Minister, meaning a return to an easier money regime, which has helped push stock prices back toward the multi-decade highs seen earlier this summer. We continue to like some Japanese stocks which we see as having decent sales growth prospects in Asia and North America while operating in an extremely productive and supportive Japanese locale.

Chinese stocks recently skyrocketed as Chinese authorities delivered fiscal and monetary stimulus. However, this has happened a number of times over the past few years (albeit with smaller rallies) and has fizzled as the measures announced did not affect enough of industrial China to lead to lasting growth. Market actions, as well as a bunch of China pundits, say this episode will be just another head fake, and that more needs to happen to reestablish Chinese economic growth, especially domestically. This makes Chinese equities, which are difficult to invest in due to their shareholderunfriendly corporate structures, even less attractive, and makes Chinese-dependent, other Asian stock markets less attractive too.

We still own Indian equities and they continue to lead growth in Asia, making them a core holding in which we could add to if there is any bout of weakness in stock prices.

Bottom line: US stocks continue to advance, led by much of the S&P 500 being involved in capital projects in technology, infrastructure, defense and reshoring. We will continue to invest in attractive companies with growth at a reasonable price while overweighting resource stocks due to their compelling valuations, supply/demand dynamics and relative underinvestment in the financial world. International stocks are less compelling in most cases, but we continue to like opportunities in India and Japan.

Bonds

US fixed income ended the third quarter with an epic rally as the Fed first promised and then delivered on a large rate cut, followed by indications of a continued rate cutting cycle, boosting short-term bonds strongly, which extended to longer-term bonds through September. However, worries about the large amount of US government debt supply, large amounts of corporate refinancings coming after the US election, and fear of an increase in future inflation due to further Fed easing, Chinese stimulus and more ECB rate cuts has led to a rise in US long-term yields, despite lower short-term yields and market indications of even lower short rates in the future.

As we've been continuing to see signs of stronger inflationary forces starting to surface once again, we are less than enthusiastic about bonds at this juncture. The US government continues to run large deficits and has to finance them in the bond market, and despite easing interest rates, the Fed is still doing quantitative tightening, allowing bonds to run off without reinvestment, putting more pressure on rates. Thus, until we see inflation ease off again and the government at least trying to rein in their spending problem, we will not be enthusiastic buyers of US bonds, especially governmental bonds.

Despite long term bonds not rallying, high yield (HY) bonds have continued to rally, keeping spreads to safer bonds very tight as equity buyers continue to buy HY bonds as proxies for equities but with higher yield (and better balance sheet preference). We are worried about the credit side of these instruments, so we are staying away from HY bonds with a slowing US consumer economy and credit distress starting to show at the lower end of the economic spectrum.

Municipal bonds are in worse shape than the federal government, being limited by how much they can borrow. Many cities survived on handouts from state and federal governments with Covid funds and leftover funds from Covid not spent. However, those sources are permanently gone, and with higher salary and costs across the board due to the past recent inflation, cities and other municipal issuers are having trouble making budgets work while continuing to provide comparable services as in the past. We are steering clear of most munis, requiring that any bonds we buy for customers be insured and from states with a runway to growth, like Texas, Florida, North Carolina, etc.

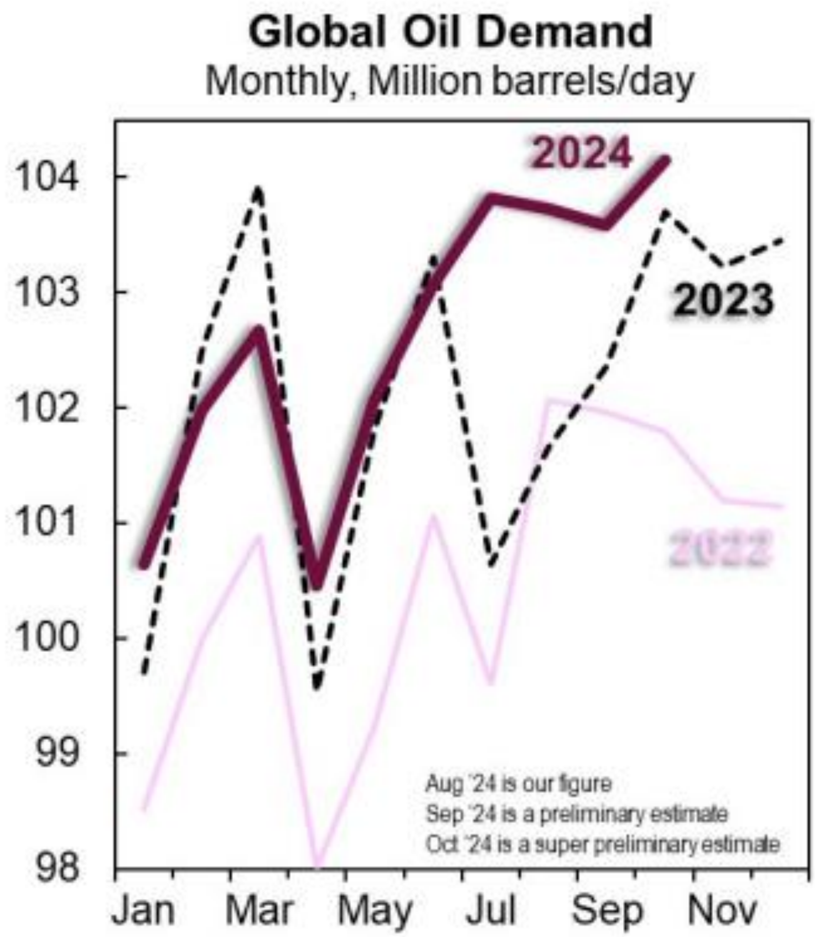
Private credit is one reason we are worried some about the financial system during the current business cycle. Private credit has grown exponentially as regulations have made bank lending much more difficult to secure and many people's multi-job situation makes them unable to fit into traditional credit criteria to secure more traditional loans. Thus, a larger percentage of the population has turned to non-bank, less regulated lending, often secured by assets or recognizance, and many times carrying interest rates that could be as high as 80% for small, unsecured borrowers. Even small corporate borrowers are generally facing interest rates of 20% or more, as opposed to SOFR (formerly LIBOR) currently at just 4.84%. We don't see this as sustainable in a slowing consumer economy, and we think that large swaths of private credit will start to see meaningful defaults after the election (when we see that massive government spending moderating, at least somewhat). The problem is that the private credit lenders have sourced funds from more traditional bank and financial market sources, so there will be some blowback in the financial system if (or when) this happens.

International bonds are facing the same issues as US fixed income, except credit conditions are probably best in the US, meaning bonds, on average, are even more risky overseas and probably facing even stronger inflationary forces in most countries, except for China, where the fear is deflation – which should be good for bonds, unless the deflation happens in the issuer of the bonds you hold, leading to default. Thus, international bonds show no attractiveness to us currently.

<u>Bottom line</u>: Bonds, in spite of their August/September rally, are much less attractive to us than almost all other asset classes. Large government deficits worldwide continue to feed supply into the financial world, while easy money and out of control government spending continues to foster inflationary impulses, further undercutting bonds' attractiveness. While short-term bonds continue to provide some yield for cash set aside for near-term needs, longer-term lending to irresponsible governments seem to be the least attractive prospect in years.

Energy

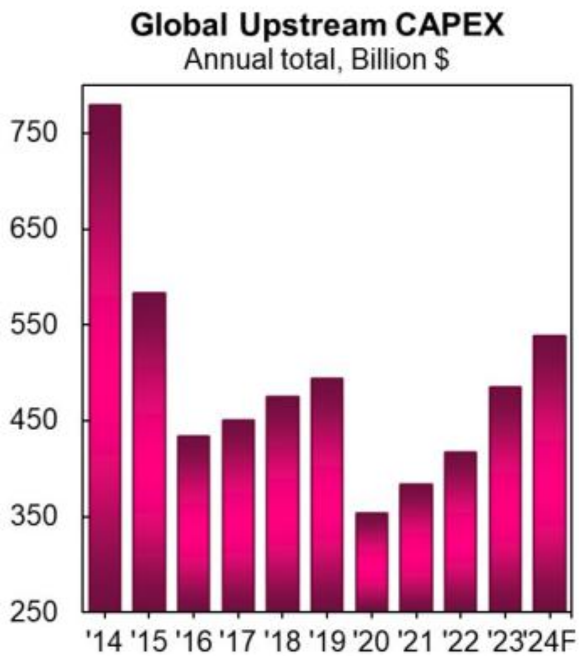
Crude oil and energy products prices continue to be weak as the fourth quarter opens as traders are spooked by the fear of economic slowdowns worldwide (especially the continuing one in China), which has led to lower diesel consumption than anticipated and thus shrinking refining margins in some areas worldwide. And a number of energy analysis organizations predict oil demand that is still growing but on the lower side of earlier growth estimates. However, this narrative of oversupply due to shrinking growth is far too pessimistic. 2024 oil demand growth is still set to exceed 1 million barrels/day, averaging the estimates of many different energy analysis sources. In his Morning Energy Update of October 10, energy industry guru Michael Rothman at Cornerstone Analytics has found his models say that global oil demand looks like it just hit an all-time high above 104 million barrels per day in September, in direct contrast to the slowing narrative:

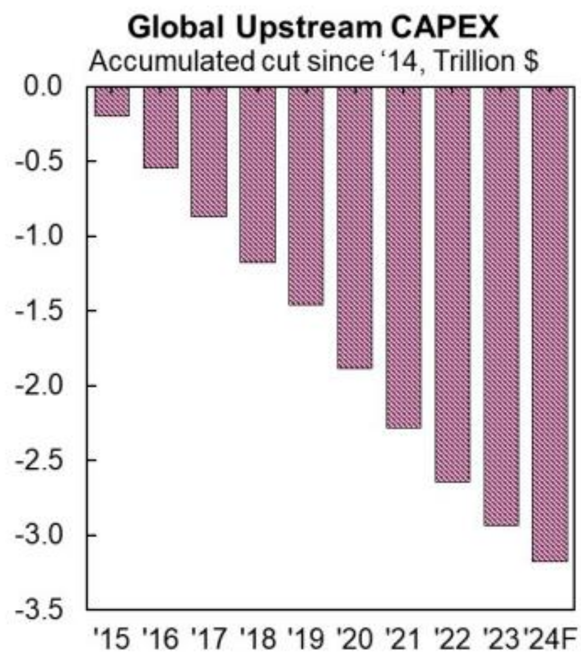


So, in reality, demand does not appear to have fallen, it is merely growing at a slightly lower rate than initially forecast. And margins, while lower, are not "unhealthy" or "showing extreme" weakness, as many media reports say, but merely are at pre-war high levels.

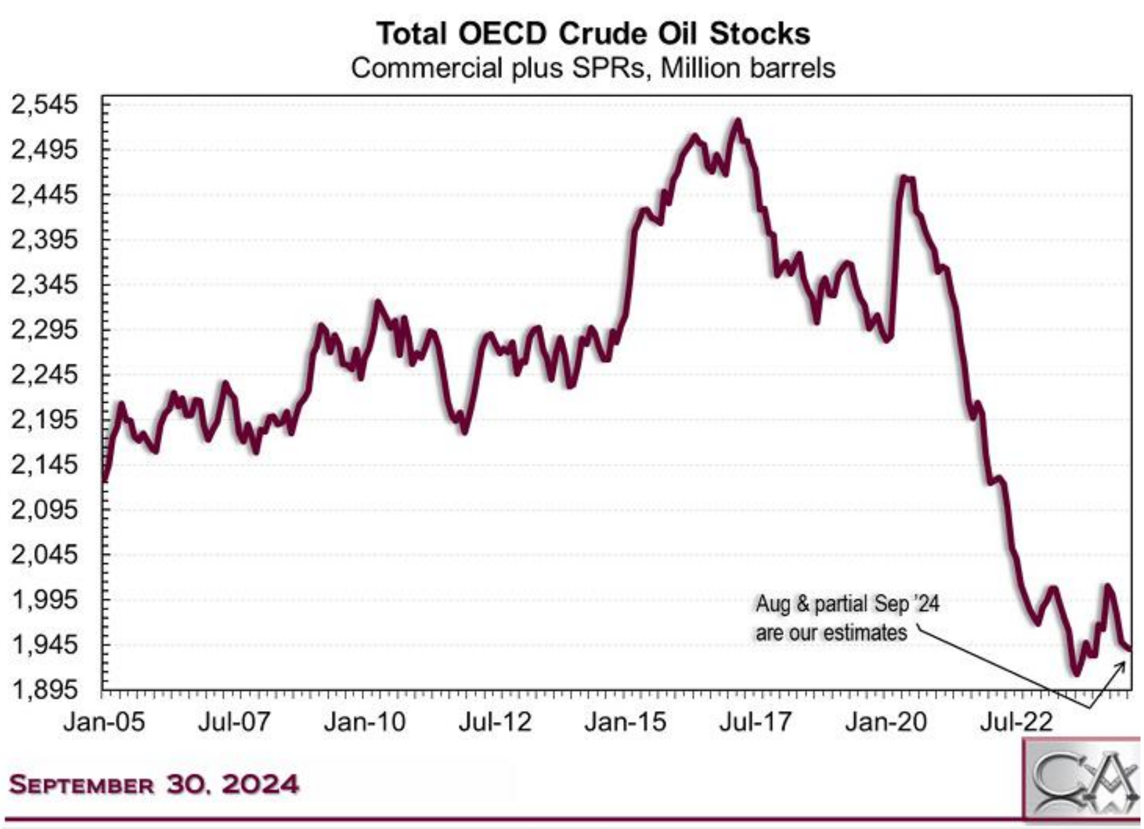
Finally, amidst the "demand scare hysteria," crude oil supplies, according to Rothman, are near their multi-decade lows, near where they were when post-Covid travel was at its zenith. This is mostly because investors have demanded return on their investments in the form of dividends/stock buybacks, resulting in continued under-investment in exploration & production that first occurred in 2014, after oil dropped sharply.

The charts on the following page from Rothman and Cornerstone Analytics in their August 22, 2024 Morning Energy Update illustrate the lack of worldwide spending on finding and developing new oil and gas. From the high-water mark of over $750 billion spent in 2014 (when oil was greater than $100/barrel), annual capex has never approached that level, and the cumulative "non-spend" since that time is now over $3.2 TRILLION, and that is when usage set an all-time high.





Meanwhile, to show returns from past investments, the oil industry has virtually used up its "inventory" of drilled-but-uncompleted wells ("DUCs"), which require a smaller investment to bring them online than a greenfield oil field. This underinvestment and using up of DUCs has led to very low inventories, as shown in Rothman's late September Morning Energy Update's chart, showing total OECD (developed world) inventories near multi-decade lows.



We believe the reality of the true supply/demand balance, coupled with any upsets from the Israel-Hezbollah-Iran ongoing hostilities or any negatives that could come from the Russia-Ukraine situation, could send crude prices much higher literally any day. The complacency of the current market is surreal and seemingly vulnerable to any shock, even a small one.

Natural gas bottomed in February, and while off its recent highs from early October, has rallied lately as current hot weather and the risk of a cold winter causes demand concerns, pulling prices up to $2.50/MMBtu, up from $1.52/MMBtu at the February bottom and $1.88/MMBtu at the August low. Producer production cutbacks and the aforementioned pickup in demand seem to be keeping a bid in natgas, and we believe the worst has been seen, especially as new and formerly damaged LNG export facilities continue to ramp up operations, exporting the US surplus to hungry energy markets overseas.

Bottom line: Perceptions of waning demand have hurt energy prices since late spring. In spite of mounting evidence that supply will have a harder and harder time keeping up with demand, and that demand is growing to all-time record highs, WTI oil prices have been stuck around the high-$60s-high $70s/barrel, making gasoline prices stay either side of $3/gallon lately. Energy stocks have mostly held prices pretty well (refiners excepted), but we think energy is the best bargain in financial markets currently, especially since they represent just 3.3% of the S&P 500 market capitalization, a very low level in a time of geopolitical upset and growing war in the Middle East.

Currencies

Currencies continue to be mentioned far more prominently than in past years, as the Japanese yen makes more headlines. After its earlier extreme weakness, the yen shot up this summer on an apparent about-face by Japanese monetary authorities. The resultant upset in Japanese financial markets, led by a big August drop in Japan's Nikkei stock market index, led to a rethinking of this rate hawkishness. The new Prime Minister has weighed in and called on the BOJ to hold off on any more action, causing the financial markets to recover but leading to renewed yen weakness.

The euro has also been chronically weak in recent years, but the ECB's reticence at easing too much before the US Fed started easing helped firm the euro versus the dollar. Recently, as US economic data has not weakened further, and the ECB has signaled it would be easing again; thus, the euro has dropped from its recent strength against the dollar.

Interestingly, the other formerly weak currency, the Chinese renminbi (or yuan), strengthened almost daily since the US signaled in late August that interest rate cuts were imminent. And the Chinese equity markets rallied in the face of this yuan strength, showing how oversold they were. However, since the start of October, the yuan has weakened versus the dollar as overseas investors' skepticism of Chinese economic progress resurfaced. We think the Chinese central bankers at the PBOC don't want a strong yuan as they try to kickstart the economy through the various announced stimuli, so we see the yuan settling back to prior lows in the future.

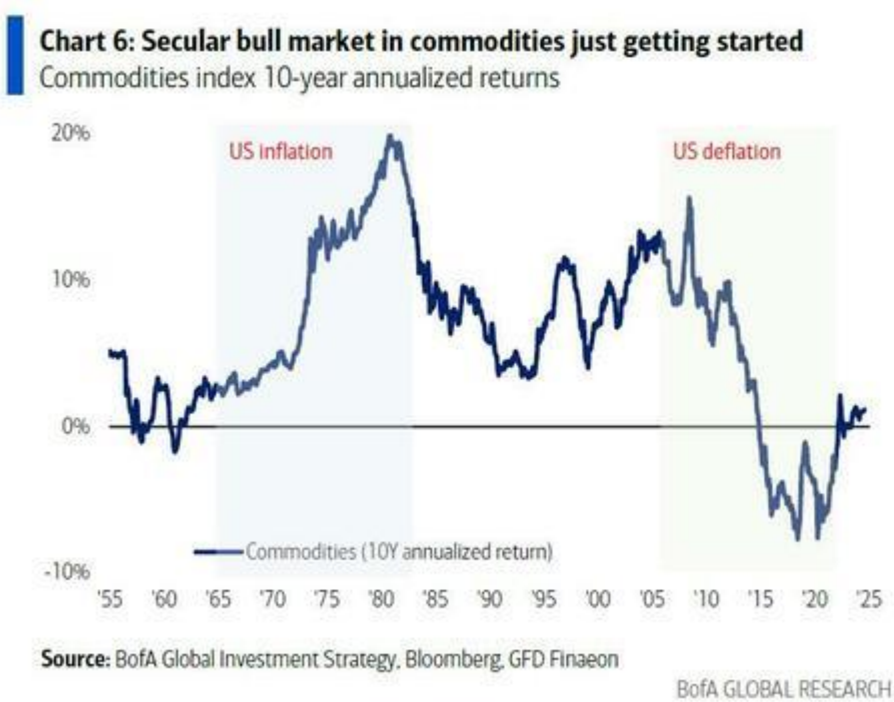
Mexico's peso has continued to weaken after the presidential election of Claudia Sheinbaum, the socialist former mayor of Mexico City, rising back to the pre-Covid range around 18-20 pesos/$. The rapid devaluation of the peso seemingly led to the Mexican government backing off on some of the more radical platform issues that international investors feared. So, it seems the peso could strengthen if investors can be convinced that Sheinbaum will not implement more radical socialist elements on Mexican business.

With weakness coming back through so many major currencies, the US dollar is gaining back some of its strength after a very weak third quarter. However, we anticipate the Fed continuing with their easing cycle during the fourth quarter and into 2025, so we see further US dollar in the future.

Bottom line: Currencies, while in the economic press frequently, don't seem to represent very interesting investing currently, and we don't anticipate having currency positions in the near future.

Commodities

In the early September article, "Hartnett: The Commodity Bull Market is Just Getting Started" (ZeroHedge on 9/2/2024), Bank of America Merrill analysts Michael Hartnett and Jared Woodard use the rolling 10-year annualized returns for a basket of commodities for a period starting in the early 1950s to gauge where we are in the commodity cycle. As you can see in the chart below, the rolling 10-year return has just started to show positive results after a more than decade-long period of US deflation that ended with the post-Covid lockdown burst of inflation. As these authors said in the excerpt we quoted in this report's Introduction, the period of 2% inflation is the outlier and that closer to 5% inflation should be considered the norm, that a 1970s style rally in commodities (see the left side of the graph below highlighted as 'US inflation' time period) is probably underway, and we intend to continue to profit from it.



Precious metals have been on a tear for the last few months, leading the commodity complex as central banks not only buy gold for their reserves but have almost universally started to lower interest rates, making precious metals more and more attractive for investors. Despite gold's recent breakout from its past all-time highs, the noted commodity trading and research shop Goehring & Rosenswajg argue that precious metals mining stocks are arguably still almost as cheap as at past bottoms in the precious metals cycle. Below is an excerpt from their late August analysis:

> In their recent quarterly commodity review published August 28, 2024 titled "What Is The Cost Of Being Early," commodity hedge fund managers Goehring & Rosencwajg show a few calculations of why they think gold stocks are still the lowest valuations in decades.
>
> "[We] constructed an index* of six major gold producers: Newmont, Barrick, Harmony, Goldfields, and Agnico Eagle. Together, these companies produce 17 million ounces of gold and hold 343 million ounces of proven reserves, giving them a combined reserve life of 20 years. With a collective enterprise value of $130 billion, these companies represent nearly 40% of the entire industry. Crucially, they all have financial records dating back to at least 2000, allowing us to compare current undervaluation with past extremes.
>
> "Consider the bear market bottom of 1999. Following two decades of inflation and the end of the Bretton Woods system, gold peaked at $850 per ounce in January 1980, only to lose 79% of its value over the next 19 years, bottoming at $252 in August 1999. The Barron's Gold Stock Index (the precursor to the HUI [gold miners' index]) mirrored this decline, falling 84% before also bottoming in 1999. In 1999, our six companies produced 12 million ounces of gold at an average cost of $200 per ounce. With gold averaging $279 for the year, these companies generated a combined adjusted EBITDA of just $1 billion. Their combined net asset value (NAV), calculated using a discounted cash flow (DCF) model with a 10% discount rate and $292 gold price, was $9 billion, compared to an enterprise value of $15 billion, implying a multiple of 1.8x.
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> "Fast forward to 2011, when gold had soared nearly eightfold to $1,900 per ounce. The HUI index rose sixteen-fold from 38 to nearly 600, while the market capitalization of the industry surged from $5 billion to $253 billion. At the market's peak in 2011, gold miners accounted for nearly 2% of the S&P 500, up from just 0.4% in 2002. The six companies saw their enterprise value rise eightfold from $15 billion to $115 billion. Was this justified? Their combined revenues increased eightfold—consistent with both the gold price and their enterprise value. Despite rising costs, EBITDA grew nearly sevenfold from $2 billion to $13 billion. Their NAV, as measured by [a discounted cash flow analysis or] DCF using a 10% discount rate and $1,600 gold price (the 2011 average) increased sixteen-fold from $10 billion to $160 billion, far outpacing the rise in their enterprise value. The companies' real option value also surged. From $18 billion in 1999, their option value grew nine-fold to $200 billion by 2011. [Their enterprise-to-NAV multiple was 1.2x.]
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> "The years following 2011 were brutal for gold stocks. By late 2015, gold had dropped nearly 50% to $1,051 per ounce, and the HUI had plummeted 85%, from 635 to 104. The market capitalization of gold miners fell from $253 billion to just $54 billion, shrinking from 2% to 0.3% of the S&P 500. Our index's equity value declined by 73% during this period, as production fell by nearly 20%, revenues by 40%, and costs rose by 22%. The companies' DCF valuation dropped by 65%, using a 10% discount rate and $1,160 gold price while their real option value halved. By 2015, the companies' enterprise value had dropped to $40 billion—equivalent to 70% of their DCF value and just 0.40x their real option value. With 275 million ounces of proven reserves, the enterprise value per ounce was $150, or 12% of the spot price. [Enterprise-to-NAV multiple dropped precipitously to 0.3x.]
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> "Today, we find ourselves at a similar juncture. Gold has rallied from its 2015 low of $1,051 to an all-time high of $2,500, while the HUI has risen from 100 to 312. Yet despite this, the market capitalization of gold miners remains at $220 billion, which is the same as it was in 2011 despite the fact that gold is 35% higher and the S&P 500's market capitalization is four times greater. Gold stocks now make up just

> 0.50% of the S&P 500, a figure reminiscent of the market bottom in 2015 rather than speculative tops. Our index of six companies has seen their enterprise value grow by 150% since 2015, while their production has increased by only 10%, revenues have doubled, and EBITDA has grown sixfold. Their NAV has tripled, using a 10% discount rate and $2,200 gold price and their real option value has risen by a similar magnitude. Despite this, they currently trade at just 0.60x their DCF value and 0.38x their real option value—levels not seen since 1999.
>
> "At the most extreme reading earlier this year, these companies were valued at just $292 per ounce of proven reserve, or 12% of the spot price—again, the lowest on record. By April 2024, gold stocks were as cheap as they have ever been. The only comparable period is the market bottom in 2015. However, unlike 2015, gold is now at an all-time high. Back then, a value investor had to anticipate a rise in the gold price to justify an investment in gold equities. That is not the case today. Moreover, in 2015, the industry's profit margins were slim—just 12%. Today, they are nearly 40%. From an operational standpoint, the margin of safety is much greater now than it was in the past."

While this is a long excerpt, it shows that valuations are importantly very low, allowing for continued strong returns for these stocks. We intend to maintain our overweight as long as monetary conditions continue to be as "easy" as they have been lately and are arguably getting easier with Fed (and other central banks) easing today and planning for more in the near future. US monetary issues are considered "easy" right now due to ease of getting financing in both the bond and stock markets, combined with the number of sources of credit: private credit, high yield credit, overseas investment in US financial markets all combine to make sourcing financing in the US right now easier than many times in the past, despite higher interest rates and the Fed continuing with "quantitative tightening" where they are letting their bond portfolio slowly run off through US government bonds maturing and not being rebought.

Base metals, led by copper, have rebounded from lows set earlier in the summer on Chinese economic woes (and worries of further softening), but Chinese fiscal and monetary stimuli, coupled with continued infrastructure spending in the US, has put a bid in many industrial metals, including iron ore and nickel. In addition, the blockbuster announcement that the Three Mile Island nuclear plant was being partially recommissioned to supply Microsoft with data center power has led to huge interest in further expanding nuclear and a jump in the price of uranium and uranium miners. We own some copper, uranium and industrial miners and intend to maintain our positions in these companies facing promising supply/demand dynamics in the future.

Agricultural commodities have recovered from multi-year low prices (wheat, corn and soybeans) while some ags in short supply, like cocoa and coffee, have risen near multi-year highs, showing the diversity of growing conditions by product. We feel these weather dynamics make the ags less investible than other commodities, so we are only minimally involved with these currently, and don't plan to increase holdings unless some trends look more long-lived.

Finally, coal usage continues to increase, although other countries, most notably China, have increased production, leading to less demand for US coal exports. Coal companies have adjusted, and while off their highs, coal company stock prices have generally held up and continue to offer very good value at current prices. We don't plan to increase our holdings unless dynamics change.

Bottom line: Commodities after correcting in late summer have very attractive growth prospects, helped by a generally weaker US dollar and in spite of growth scares in Asia. Central banks continue to up their reserve holdings in gold, and some (most notably Russia) are also accumulating other precious metals like silver and platinum, adding to demand from their traditional industrial users. Infrastructure buildout in the US and around the world continue to underpin demand for industrial metals around the world, in spite of China's sputtering growth. We continue to think the attractive valuations, increasingly attractive supply/demand characteristics of many of these markets, and the geopolitical upsets that add friction (and thus added costs) to production and distribution of raw materials will continue to push prices up, benefitting the producers and transporters of raw materials we own in our portfolios.

Kanos Quarterly Commentary

Ask the Portfolio Manager

As we periodically do, we are going to take some recently posited questions and use them as the basis for a question-and-answer format for this quarter's Kanos Commentary. We hope this is informative as well as helpful for letting you, our treasured customer, understand better how we are thinking about this confusing and turbulent time in our nation's history and in financial markets.

Q: What do you think is going to happen in the November election, and how will it affect financial markets, and in particular, our portfolios?

A: This is supposedly the #1 question that financial professionals have been receiving for the past few weeks. Watching financial media (as we have to do), the traditional thinking is that a Trump victory will lead to strength in industrials and energy, while a Harris victory is better for alternative energy, and big tech. We believe that while the President makes a lot of decisions and determines a number of important policies, the financial endgame is generally more dependent on the makeup of the Congress and the inertia (or lack of it) in current government programs.

With those thoughts in mind, we believe there will be some different winners and losers depending on the presidential election, but we believe that Congress will be slightly less dominated by the Democrats, meaning fewer large spending measures and a focus on how money is spent, hopefully not expanding the over-the-top government spending of the past five years.

However, we are strongly of the opinion that: 1) both candidates will want to impose their economic framework on the nation, which will involve at least some new spending initiatives, 2) the currently approved spending on semiconductors, infrastructure and alternative energies are embedded and will almost certainly continue in the same or similar form as they currently are, keeping government spending relatively high, and 3) military spending on US military infrastructure has been downplayed for years and will need to be addressed, upping military spending when we can least afford it, and 4) mundane infrastructure (roads, bridges, etc.) in less-favored communities continues to deteriorate in a lot of cases and will require rebuilding over many years, again regardless of the winner. These things mean that targeted industrial and energy companies will be good investments for many years, regardless of the winner. Alternative energy will see big winners and losers depending on the next president, but investment in new energy technologies will continue across the spectrum of technologies, regardless of who is elected.

Thus, we think that there will be winners and losers depending on the next president, but they will be minor compared to the economic and financial themes currently in the world financial markets, and thus, they should not impact our portfolios appreciably.

Q: You have said in past letters that the US will have a recession. It doesn't seem to have happened yet. Do you still think a recession will occur in the near future?

A: The straight answer is yes; we still think there will be a recession. The nuance is that politically a recession is awful, so government spending continues to be in overdrive to try to head off any slowdown, with the Fed doing its part to try to ease financial conditions (lowering interest rates, has repo & reverse repo lending to assist large financial companies to optimize their liquidity) to assist in the effort, attempting a "soft landing" where the US economy cyclically slows but then starts to recover without much economic pain to too many inhabitants.

While we think it's possible to 1) spend the country out of recession and/or 2) lower interest rates and ease financial conditions so that an economy has a soft landing, we think it is very difficult and probably almost impossible given the high amount of debt: governmental, corporate and personal, in the financial system right now. Easy money leads to good and bad investments – the past few years have seen so much easy money that some of those inevitable bad investments will pull down economic growth in the next few quarters.

Also, the lower end of the economic spectrum of the US is hurting right now, regardless of interest rates falling 0.50% lately. Restaurant traffic is down appreciably and a number of chains are declaring bankruptcy, credit card debt is skyrocketing with <u>average</u> interest rates over 20%, retail sales are stagnant with inflation still around 3%, which means real retail sales are falling – all this says we are technically in recession right now for much of the consumer economy, even if economic statistics cannot seem to capture this.

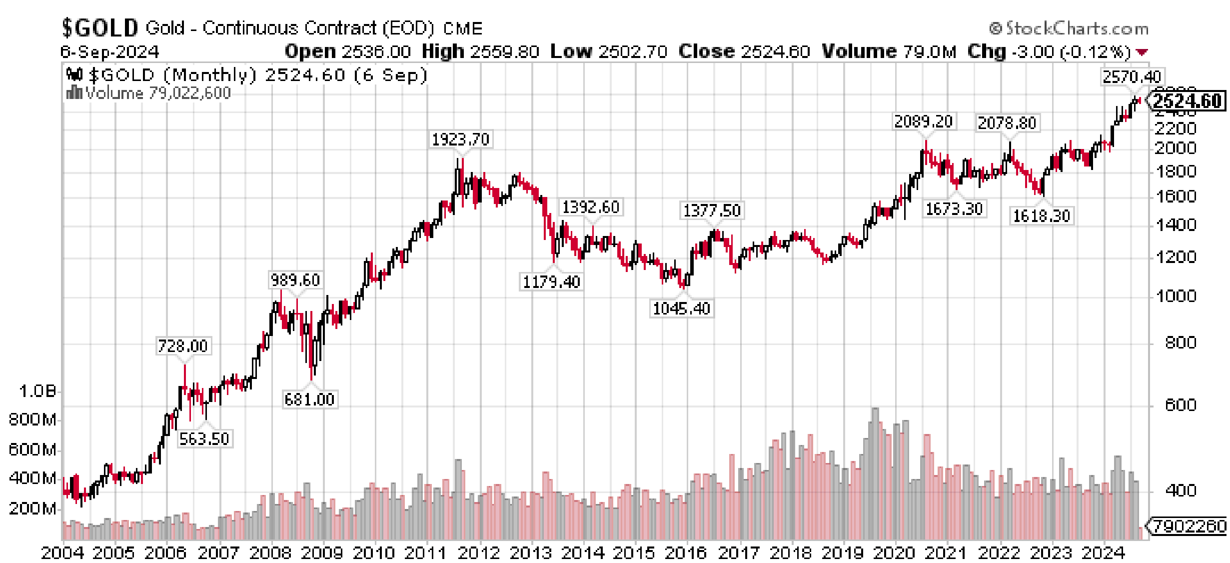
Q: Kanos always seems to have an overweight in precious metals and energy. Is this permanent or can you share what would change your mind about one or both positions.

A: First and foremost, we don't have any "permanent" positions in your portfolios. We try to gauge the economic, financial, political and personal situation factors in each person's portfolio, and then we construct portfolio positions to fit these factors and our customers' unique specific risk profiles so that their portfolio is best suited to their needs and lifestyle.

Before answering the rest of this question directly, we want to address our portfolio manager's breadth of experience as a backdrop for his stance on certain sectors. Kirby Shanks: "My first job out of college in Houston was working for an oil market pricing service based in London named Petroleum Argus. During my employment there, in which we daily surveyed the US oil and products markets and sent reports about that daily activity to Argus' worldwide clients, the Crash of 1987 occurred in the stock market. I had inherited a little money when first my grandfather and then my father died before I attended college, and these funds were being managed by a very successful portfolio manager, my mother, Josephine Shanks. I remember calling her up in the afternoon when stocks were down more than 20% during that October 19th day, and asking: 'What are we going to do?!?' She answered (and I paraphrase her answer): 'We are not going to do anything today – we are going to sit and hold the good companies we've invested in and re-evaluate going forward, as needed." I remember this as some of my bedrock financial training: 1) Don't panic, 2) Make decisions at the right time [and on an on-going basis], 3) Believe in your experience and your research and don't get out of positions for the wrong reasons, and finally 4) Markets can move radically, especially down, and you do want to protect your portfolio against that, at least partially, when financial conditions (or even politics or geopolitics) seem stretched or particularly volatile. At Kanos, we still incorporate these lessons in portfolio management and decision-making. Our experience has been shaped by a lot of factors, including over a decade in natural gas trading and transportation, business development, investment banking, finance and compliance. The Crash of '87 was just one important piece in our experience."

With that in mind, we first were exposed to gold and gold stocks as some financial commentators saw budget deficits and the concomitant national debt growing in the late 1980s. However, we didn't invest in gold or gold stocks until the early 2000s, after Fed Chairman Alan Greenspan took interest rates down to 1% after the relatively mild recession of 2001-2002 and held them at that level for a couple of years. The Fed did this to try to kickstart the industrial economy after the Dotcom crash in 2000-2002, and they judged that lowering interest rates to the lowest in decades would not stoke inflation because of the deflation being imported from goods and services outsourced to East Asia for the last 10-15 years. We, having just formed Kanos, thought that too-low interest rates and overly plentiful liquidity would not only jumpstart the US economy, it would overheat the US and Western economies as other countries followed suit, hurting the value of the US dollar (and other Western currencies, like the euro, as well as Asian currencies like the yen, thus pointing to investing in investments that would benefit from lower currencies – and our precious metals investments were born. Those conditions described above haven't really changed since the early 2000s (there was a period from 2012-2016 when a Republican Congress blocked a Democratic administration from overspending and goosing the US economy, which hurt precious metals prices during that period), so our belief that metals investments would do well has continued due to continued financially easy conditions.

And that belief has borne fruit. Here is a chart of gold prices since 2004, when we started managing investments at Kanos:



We believe the Fed-driven liquidity, as well as fiscal stimulus from the US Government, is ongoing and won't change with the election of either Harris or Trump, so we anticipate continuing to invest in precious metals and the companies that produce them as long as these conditions persist.

We have invested in precious metals mining companies also, and their performance has not matched the performances of the prices of the metals themselves during large stretches of this 2004 – present period, due mostly to poor management of the companies (since replaced), leading to disillusionment in the sector by US investors. Management of all major US and Canadian precious metals mining companies have been replaced since the early 2010s period of extreme underperformance, and many managements are better aligned with creating and building shareholder value. We have concentrated our investments in companies that we believe have rich deposits, shareholder-oriented management teams and have most mines of their mines in safer locations (i.e. US, Canada, Mexico and Australia) to ensure better financial results.

The Managers of Kanos Capital Management