Kanos Capital Management

Quarterly Investor Letter

Fourth Quarter 2024

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Fourth Quarter 2024 Investor Letter

Fourth Quarter Market Review

The fourth quarter of 2024 was a tale of three parts: 1) pre-election uncertainty, 2) election resolution/business optimism and 3) reality kicking in with fewer rates cuts, more tariffs and growth questions. October was marked by uncertainty over who would be the US political leader, whether there would be long election challenges and whether there would be violence, from the left or right or both. The November election changed all that, providing election certainty (no material challenges), no real violence and a center-right candidate who promised laissez faire capitalism, renewal of tax cuts, deregulation and a fight against inflationary forces. These factors caused US equity markets to rise strongly, driven by hedges being lifted, investor optimism, and business owner optimism. However, mid-December brought a Federal Reserve decision that, while lowering rates, indicated fewer 2025 rate cuts. In addition, the size, scale and extent of possible future tariffs caused some re-evaluation of growth, as did the slowing of auto and home sales. Major US averages set records in early December but fell much of the rest of the month, with the S&P 500 managing just a 2.4% gain for the quarter. European stock movements were more muted, also gaining during November but otherwise relatively flat. Asian shares had a slight upward bias, although China's stimulus-led market pop in September retraced much of its advance, leading to a down quarter.

Looking Forward

Introduction

2025 is set to build on the resolution of many questions from 2024: 1) an election that resulted in a regular, peaceful transition of power to 2) a more business-centric, US-focused incoming administration, which 3) reset financial markets worldwide, and 4) pointed to a more hopeful and promising future in both social and economic spheres.

In the shorter-term, the near euphoria that permeated US markets from early November to mid-December may have ended, and more realistic attitudes and thus, valuations, are hopefully in our short-term future as growth, profits and valuations come into more balance.

The US continues expanding its newest phases of growth, led by high tech but also reshoring, which continue to make the US the most attractive place to put money to work, although some sectors are more attractive than others.

Much of the rest of the world continues to struggle politically, as many governments have fallen as more socialistic efforts in economies have proven to hurt growth (namely Canada and Germany, with France, and possibly England and Japan to follow). Their citizens are voting out old leaders and looking for new leaders to help rejuvenate their economies, looking at Milei in Argentina as an extreme example and Trump in the US as a new example.

This transition, if successful, will lead to many new possibilities for our investments. Currently, with many countries in poor economic shape and their immediate futures in doubt, we are monitoring but less inclined to invest at the moment. China is a good example, with their property markets still a mess, and their post-Covid lockdown economy still growing far less than in recent decades (and it may not be growing much at all); their stock market has few attractive candidates for our investments, and their lack of uniform rule of law makes the country almost uninvestible.

Other situations involving conflict, from the Russia-Ukraine War, the Israeli-Gaza and Lebanon/Syria situations, make those parts of the world less attractive to us to invest in currently, with their less transparent businesses and business practices.

Thus, we will look at attractive economic, political and trade-centric situations, which seem to be more so in the US markets and international companies supplying the US, while we continue to monitor international markets to see if we can find new situations that will attract some of our investment capital.

Economy

We are bullish on the future of the US economy, but we are bothered by so many contrary indicators that say so many individuals are in trouble economically. Looking at employment and GDP statistics and reports, the domestic economy continues to grow steadily, employing a large number of Americans and producing more growth than was typically seen pre-Covid. However, we also see manufacturing statistics and surveys that show continued lack of growth and a service sector which is growing but marked by constant inflationary cost increases. Meanwhile, growing debt, increasing bankruptcies and fiscal distress from a large number of lower (and middle) income people in the US point toward less economic opportunity. We know the federal government has been overspending, running up a horrendous deficit year after year, and stimulating the economy more than normal. But anecdotally, it seems that so many places we see have an uncomfortably large amount of commercial real estate unrented, places left to go derelict and more and more homeless people in areas where we have never seen them before.

The expansion of our digital infrastructure (data centers and their associated network infrastructure), the expansion of our green energy and now traditional energy generation and networks, the repair and refurbishment of much of our present roads, bridges and other more traditional infrastructure and our continuing advancements in artificial intelligence, advanced computing and space lift capabilities point toward plenty of continuing and future economic engines that will be massively productive and provide firepower for years, if not decades, of economic growth. On the other hand, we are concerned that another shock, even a fraction of the size of the Covid lockdowns, could tip over what seems like a fragile US economy when it comes to people in the lower economic strata.

Finally, we think the more business-friendly, law-and-order and fiscally planning new administration will be less of a hindrance for the US economy than those of the last few years. Pledging to cut red tape, streamline regulation, pave the way for more (and thus, probably cheaper) energy production and trying to reshore (or at least friend-shore) more industries should allow the US economy to grow more easily, hopefully allowing more small businesses and the jobs they create to be established and contribute to a vibrant US economy.

Most European economies have softened, led by France, who is having political upheavals (as Macron has difficulty forming governments as his party slowly loses its power) and Germany, which is bedeviled by high costs for labor and energy but has lost its ability to grow its economy due to poor government policies, domestic and EU regulation and relative lack of innovation. Other European economies are better but kind of limping along with slow growth and lots of EU and domestic regulations that can handcuff economic growth.

Japan's economy has been recovering from its long malaise, with growth expected to approach 2% this year after decelerating after the boost from the end of the worldwide Covid lockdowns. The growth is sustained enough to give Bank of Japan (BOJ) leader Ueda confidence in announcing that rate increases are on the docket for BOJ meetings going forward. However, growth has not exceeded 2% since 2021, so economic gains are still relatively small and fragile, leading to the BOJ's cautious stance toward removing stimulus quickly.

China's Peoples Bank of China (PBOC) continues to coordinate with the Chinese government to provide stimulus to the ailing Chinese economy in order to try to stimulate things enough to return to real sustained high growth seen in China from the late 1990s through the mid-2010s. However, the Chinese Government, headed by the Chinse Communist Party (CCP), wants to keep inflation down to keep the populace from growing more unhappy over rising inflation, so the CCP has kept the Chinese renminbi from depreciating, keeping monetary conditions relatively tight and the problem real estate sector continuing its problems. Many economists believe that until the Chinese can let more firms fail in their economy, clearing away the problem companies/assets that continue to keep industries weak with discount pricing, the economy will suffer. Only when companies and assets are liquidated, new owners and new capital take over, and business conditions improve does the Chinese economy get back to more sustained and higher growth.

Bottom line: We continue to be relatively fully invested in attractive situations with a relative margin of safety but watch economic reports carefully to make sure we keep an eye on how the economy appears to be shaping up. We see promise in the US and other high-tech oriented economies, but we also see so many statistics that show there is weakness in consumers' balance sheets and ability to live (and pay back debts). We are concerned about this dichotomy, but we think that cutting down government interference and its costs will help productivity and profitability, in both the US and worldwide economies, but only when governments step back from their more activist modus operandi of the past 10-15 years.

Equities

The US equity markets, after banner returns in both 2023 and 2024, have had some indigestion during 2025 so far. One reason is the valuation/growth prospects/past performance of the biggest 50 stocks. In a December 18, 2024 white paper titled, "Market Cap to GDP & the Importance of Basic Arithmetic," research house Kailash Concepts shows in the graph below how the largest 50 stocks in the US are at all-time highs against the US Gross Domestic Product. '50 Largest to GDP' peaked at 74% in the 2000 dot.com bubble, beat that record in December 2021, reaching 97% during the post-Covid stimulus 'Liquidity Bubble' and now are at 110% during the 'AI Bubble.'

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The indices have been driven by large technology companies' spending and implementing new AI initiatives, with investors betting that these investments will further cement these companies as years-long big winners in AI and future technology (see the Concerning Technology section at the end of the Equities Section below).

As we continually examine the economy (and world economies), we see many sectors that are growing or have the potential for growth in the near future, and many of these companies, especially international companies, are valued at fractions of their past valuations.

The sectors that appear most attractive to us for their undervaluations are Materials, Energy, and Industrials. To a lesser extent, Financials, Utilities, Healthcare, Real Estate and Consumer Staples. Currently, valuations make Technology, Communications and Consumer Discretionary less attractive. Here are some reasons why we are invested or considering investment:

Materials, Energy, and Industrials (attractive): Materials companies are attractive for the ongoing infrastructure and reshoring initiatives in the US; internationally, less developed nations will continue their growing appetite for materials for development. Energy companies are attractive because of the continued new highs in energy usage worldwide, from 2% growth in petroleum to 4% growth in coal. Industrials are reshoring and expanding to manufacture and build US data centers, networks, advanced manufacturing (think chips) and reshoring of lower tech industries to support those efforts.

Financials, Utilities, Healthcare, Real Estate and Consumer Staples (some attractive elements): Financials will have to keep the monetary side of the economy flowing, but the amount of credit outstanding and refinancing risk make the risks to the system higher than normal. Utilities will be providing the power and power lines for the infrastructure build and expansions, but they've been bid up as "surrogate AI investments," so they are more highly valued than normal, so less attractive. Healthcare is being targeted by the new administration as a place to cut costs / transform, so the past profitability / dividends are in question and so less attractive. Real estate still has many overbuilt sectors and overleverage that still must be reconciled, so the sector is less attractive until the post-

Covid conditions rationalize more clearly. Consumer Staples are highly valued and still exposed to rising raw materials and labor costs, so the sector is less attractive presently.

Technology, Communications and Consumer Discretionary (not as attractive): Technology and Communications have thrived as the biggest companies have expanded their footprints and other tech infrastructure companies have benefitted from the cloud, ad sales, streaming, AI and media expansions (social media, podcasts/DIY [like YouTube] and entertainment [like broadcasting football games]). All these initiatives have consolidated lots of profits in mega-tech firms (Microsoft, Apple, Amazon, etc.) and comms firms (like Google and Meta). Valuations are stretched for almost all growing companies, as we pointed out earlier, making these sectors less attractive to realize further investment gains. Consumer Discretionary is less attractive because of the majority of the US consumers' tight financial situations, making discretionary income tighter and making current valuations look less attractive. Tesla as a consumer discretionary stock is also priced for perfection, skewing the sector to an even higher, less attractive valuation.

International stocks (not as attractive): International stocks continue to be at much more attractive valuations than their US counterparts, offset somewhat by investment analysts' estimates of more modest growth in overseas companies. We continue to have doubts about sustainable growth in many parts of the world, especially with a strong US dollar that tends to pull liquidity from around the world to the US, making it harder to finance projects in non-US locations. US corporate earnings growth continues to look more attractive than most of the rest of the world, especially with China failing to reach its GDP growth goals, and the Chinese authorities not stimulating in a way that will change the current paradigm of their economy.

Thus, while we own some foreign stocks, we are still investing in a US-centric manner as profit growth, attractiveness of prospects and strength of the US dollar makes equities look best in the US currently. We continue to monitor international markets and look for attractive situations in order to look for good diversifiers and less correlated assets.

Concerning Technology

An article came out recently that states some of our reservations very well. Issued on January 13, 2025 by Oaktree Capital Management's Howard Marks, a 50+ year veteran fixed income investor and financial company executive, the article is called "On Bubble Watch." He talks about his experience and the various elements that have to come together to form what most people would characterize as a bubble. We have those elements currently: euphoria, willingness to pay any price to "get in," and "fear of missing out." Mr. Marks also illustrated how the 'Magnificent 7' stocks (Apple, Microsoft, Nvidia, Alphabet (Google), Amazon, Meta and Tesla) represented: 1) almost 33% of the S&P 500 at the end of October 2024, 2) this was double their share just five years ago, and 3) at 33%, their share is much higher than at the top of the dot.com boom in 2002, when the top seven stocks only represented 22% of the S&P 500.

More instructive to us is what has happened in the past, and how it could apply to our present-day markets. In the late 1960s-early 1970s, "new" post-war companies grew quickly into a growth stock mania, with the top stocks known as the 'Nifty Fifty' on Wall Street. These technology and consumer products companies sold for P/E ratios as high as 90x for many years, but the bear market in 1973-74 led to 50% losses on average for stocks, and many of the Nifty Fifty fell as much as 90% as profits

eroded and their market multiple was cut substantially. In fact, Mr. Marks estimates only 50% of the companies even survive today, with some still around but worth little (Xerox, Kodak, Avon, etc.).

The 2000 bubble is similar; Mr. Marks shows only 6 of the top 20 companies by market cap in the S&P 500 in 2000 are still there: Microsoft, Walmart, ExxonMobil, Johnson & Johnson, Proctor & Gamble and Home Depot. Notice there's only one tech stock included! Many of the large tech stocks are still down more than 80% from their 2000 peaks.

Finally, very recently, a Chinese tech company released a new AI program named DeepSeek. They said it was developed at a small fraction of the $100 billion+ cost of US large language models (LLM), requires less than 10% of what US AI engines need for operations and can run on a large workstation instead of a data center array of thousands of expensive chips. While some of the cost and energy savings seem exaggerated (it may have been trained off another LLM, it is open source (able for anyone to see and alter the programming for their own usage) and clearly involves clever engineering to cut down on cost and operational bulkiness. DeepSeek may not be the "AI killer," however, it calls into question the extremely high margins and thus valuations of a number of tech firms, including: 1) chip designers (Nvidia), 2) chip manufacturing supply chain companies (ASML, Taiwan Semi), 3) LLM model developers/hyperscalers (Microsoft, Alphabet/Google, Amazon and Meta) as well as 4) the whole data center development "food chain" (Vertiv, Dell [computer infrastructure], Vistra, Constellation Energy [energy suppliers] and others, including energy, materials and industrial supply companies specifically targeting data center ramp-ups).

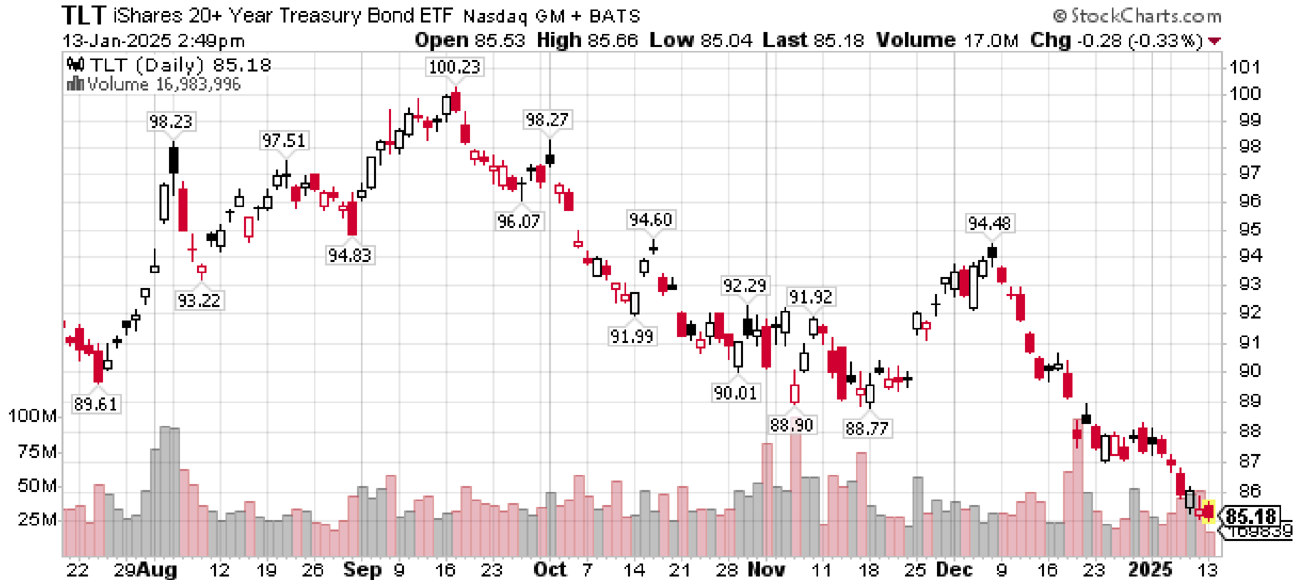
This explains our reticence to devoting much of your capital to momentum-driven but overvalued stocks. But the there is a valuable flip side: As Kalish points out in their white paper, if the 50 largest stocks account for 50% of the market's total valuation, <u>then the other 5,116 stocks in the United States are worth examining and many worth owning due to their undervaluations.</u>

<u>Bottom line</u>: US stocks continue to have the most attractive sectors and prospects in our opinion. Infrastructure and advancing technology, with all the materials, energy, parts and know-how needed to build, power and foster further growth, are our current concentrations. We are wary of the overvaluations that exist and the possible building up of risks in certain sectors, but we believe the new administration's business-centric focus will help address some of the imbalances and allow the US to continue to grow economically, and thus our portfolios to grow continuously. International situations are currently not as attractive on the whole, but we own international stocks and will continue to look to add as conditions dictate.

Bonds

Well, it wasn't supposed to happen like this. The Fed started their cutting cycle in September 2024, cutting a total of 100 basis points from the Fed Funds rate in three meetings. However, longer-term interest rates, as represented by the 10-year Treasury bond, <u>have risen</u> 115 basis points during the same period, making longer-term financing more expensive and possibly signaling that the bond market believes the Fed has made a policy mistake lowering interest rates before inflation has reached the Fed's target and at a time when employment statistics and GDP growth have held up, signaling at least a slow-growth economy.

Thus, the bond market has been falling, as shown in the following graph from StockCharts.com illustrating the movements of the exchange traded fund TLT, which mimics the prices of longer-term Treasury bonds with a weighted average duration of 20 years:



As you can see in the graph above, on the day of the Fed meeting (September 18) in which they had telegraphed that they would start lowering rates, the TLT ETF traded as high as $100.23/share, but after the 50-basis-point cut in rates, long bonds started trading down in almost a straight line, bottoming around the early November election. The hope for greater growth and stalling inflation with a new administration allowed bonds to rally into early December, but a number of continued upbeat economic statistics and upticks in inflation statistics have sent long bonds to a new string of losses, totaling 15% since the first cut, a very large loss in a short time for fixed income investments.

We will be examining the case against owning bonds further in our Kanos Commentary at the end of this Investor Letter, but we continue to shun fixed income investments of longer duration because we believe there are growing risks to more inflation as well as risks to refinance all the currently outstanding debt as well as the costs in the system that will add to that debt over time. In 2025, estimates are that the US Government alone will have to rollover around $6 trillion of current debt, much of which is T-Bills that for portfolio prudency purposes should be converted into longer term debt. In addition, as much as $4 trillion new debt will need to be sold. More on the implications of these very large numbers in the Kanos Commentary.

US high yield debt (HY) has performed well over much of the last two years as investors have treated these lower-quality bonds as equity surrogates, mirroring moves in the US equity markets. In the fourth quarter, HY did not perform as well as stocks, as the headwind of falling government bond prices (rising yields) pulled at HY returns. We are concerned about HY in the future because much of it was refinanced in the post-Covid lockdown low yield regime and is coming up for refinancing in the next couple of years at interest rates that could be 2-3 times higher than they are currently having to pay. With the US economy growing slowly and only strongly in a few sectors, we think HY could start to show weakness as liquidity gets pulled more and more into government bonds' near-insatiable need for deficit financing.

International bonds are not attractive at this point. With European countries running deficits, their need for additional deficit funding has driven yields up in lockstep with US yields, but without the benefit of the strong dollar, meaning US investors would be losing on the currency piece of the investment, dampening yields further. Japanese yields have also been rising, as the Bank of Japan continues to remove stimulus (at a snail's pace, however) as the economy strengthens slowly, but absolute yields are still the lowest in the developed world.

The interesting anomaly are Chinese bonds. They have fallen to the lowest level ever as the country wrestles with a deflationary depression from their massive property price decline, which has herded Chinese savers into government bonds as a safe haven for capital for the past few years (and into gold also). The below graph, from the Trading Economics website (tradingeconomics.com) shows Chinese bonds' falling yields for the past four years, as the Chinese economy has never really recovered from Covid lockdowns and the aftermath afterwards in their property and export markets.

Despite this bull market in Chinese bonds, they are not attractive as investments for US investors, since the risk of a currency debasement could destroy any investment gains as the Chinese authorities try to help the economy recover from its doldrums.

Municipal bonds, except for those that are insured and from fiscally prudent states like Texas, hold little appeal for us at this time. Yields are attractive, but interest rate risk and credit risk combine to make these riskier investments than they've been in the past.

As we mentioned in our last Letter, we are concerned about private credit, which has grown to a larger component of the US fixed income universe. The lack of transparency, the unknown amount of mark-to-market losses, and the possibility of deterioration of repayments make us leery of such investments as large swaths of the US population have trouble making ends meet.

Bottom line: Bonds continue to be much less attractive to us than almost any other asset class. We examine more about their risks in the Kanos Commentary.

Energy

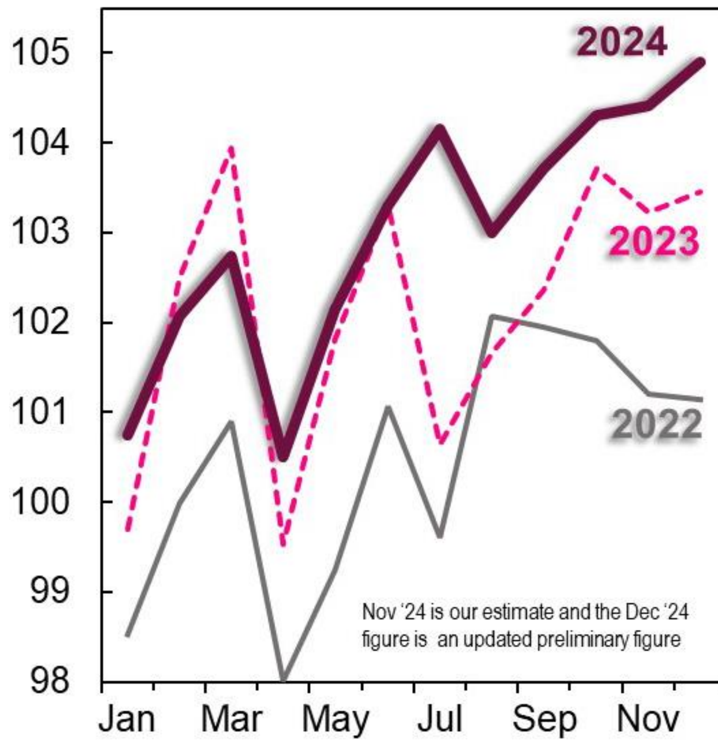
Energy prices fell during November as investors embraced the Republican “drill baby drill” mantra, fearing an increase in US crude supplies would contribute to the perceived supply surplus developing worldwide due to a weaker Chinese economy.

However, as reflected by the 5% price rise in West Texas Intermediate (WTI) crude oil and the nearly 6% rise in US natural gas prices, increased demand and less worry over too much supply have combined to end the correction in energy prices.

Now in January 2025, energy prices worldwide have continued to rise due to a number of factors. First, a colder winter than originally anticipated has driven up heating demand in both Europe and North America. Second, continued draws in US (and worldwide) inventories have signaled traders that supply does not seem to be the problem originally thought. And third, political and geological concerns may weigh on supply, meaning not only will no glut form, but a supply deficit may be forming. Russian production has been falling since Covid, when production was scaled back across the world, and their older fields did not return to the same level of production afterwards. In addition, after Russia’s attack on Ukraine, production was further negatively impacted due to Western sanctions prohibiting high-tech Western oil services companies from continuing to stimulate older Russian fields, resulting in accelerating natural declines. Finally, mid-January 2025 sanctions were reimposed on Russian transportation assets during the last days of the Biden Administration, tightening supply deliveries to large demand centers in India and China, driving up prices further. Finally, the Biden Administration loosened or discontinued some sanctions on Iranian production, allowing Iran to produce as much as they could manage; the incoming administration may reimpose “maximum pressure” on Iran, reducing their ability to export and tightening the world supply/demand balance further.

Finally on supply, the incoming administration has pledged to remove regulatory, environmental and political roadblocks from energy development in order to boost US production significantly, and specifically targeting more shale production. This easing of regulatory burdens may lead to a small increase in US production, but it is unlikely to have a big impact on oil markets and pricing due to slowing shale oil production growth and the abovementioned pressure on supply and thus prices.

In aggregate world demand is not as dependent on Chinese demand as everyone thinks, and also, just because China has slowed down economically does not mean other East Asian economies are using less energy. In his Morning Energy Update of January 3, 2025, energy industry guru Michael Rothman at Cornerstone Analytics has found his models say that global oil demand looks like it just hit another all-time high, averaging above 104.5 million barrels per day in December, in direct contrast to the popular narrative promulgated by the International Energy Agency (IEA) that demand is weak and possibly falling. The graph below from the 1/3/25 Morning Energy Update shows this more graphically:



Our last Letter highlighted the continued draws in worldwide inventories, which have continued, as well as the relative lack of industry capital expenditures needed to keep world production above 100 million barrels per day. Those trends have continued into 2025, with crude draws continuing at unseasonably high levels as it appears production is having a difficult time keeping up with worldwide demand, despite the continued mantra of a weak Chinese economy supposedly causing a worldwide crude glut.

Natural gas has finally woken up after many thought the North American supply/demand balance could never equalize. Prices almost doubled during the fourth quarter of 2024 as colder weather in North America caused early winter supply concerns while colder weather in Europe and Northern Asia filled North American LNG export capacity, pulling on supplies even more.

While cold could moderate the rest of the winter, sanctions on Russian LNG exports and sabotage of world natural gas pipelines (the Turkmen gas pipeline was just attacked in the Black Sea, in addition to the 2022 destruction of the Nordstream pipelines) point to continued larger reliance on LNG imports into Europe and Asia, most sourced from the Middle East and increasingly, the US, which is now the largest world LNG exporter. We continue to think that natural gas, while volatile, is an attractive investment over time, and we continue to own energy producers, some of which are more natural gas oriented.

Bottom line: Perceptions of flagging demand that led to underperformance by energy and energy companies in the fourth quarter have proven to be misguided as demand worldwide continues to grow while geopolitical and geological issues continue to show that worldwide production is having a harder time keeping up with demand than many in the market think, highlighted by low and still falling inventories. We continue to think oil is undervalued and will stay invested while looking at

other attractive situations in the energy sector worldwide, especially as many companies pay attractive dividends.

Currencies

Currencies have been dominated by the US dollar lately, as the US economy continues to show growth, long-term interest rates have risen (despite the Fed's efforts) and US equity markets have continued to advance, pulling capital from around the world. The US dollar rose approximately 9% in the fourth quarter, boosted by the election results and resolution of many uncertainties that had swirled around the US pre-election.

The strong dollar has put pressure on all other world currencies, as capital is attracted to US investments or at least US dollar-denominated investments, making growth harder around the world. Estimates we've heard put the dollar as much at 15% overvalued, and while the incoming administration's planned activities have resulted in dollar bullishness, it may not prove to be so in practice.

In his first term, President Trump was in favor of a weaker dollar, which occurred from early 2017 (after his first inauguration) through early 2018, while the dollar slowly recovered after that due to a strengthening US economy. We anticipate that the new administration will welcome a weaker dollar in 2025, which could occur because of increased bond issuance. However, government shrinkage through the proposed Department of Government Efficiency and continued strength in the US economy versus continued weakness in other world economies could continue to put a bid into US dollars.

The other currency that is interesting here is the Japanese yen. The yen has been weak for decades, and only in the past year plus have interest rates been allowed to rise, as the Japanese government and BOJ collaborate to continue to foster renewed growth in the Japanese economy. Now, as yields rise and the economy continues to grow, the yen could appreciate against most currencies, especially the US dollar, as capital sourced in Japan and exported to the US is repatriated to pay off Japanese loans, requiring selling US dollars and buying yen. The amount of yen funding of assets, projects and investments worldwide is incredibly large, and a few speculative ones were unwound in one day last August when the BOJ signaled higher interest rates were coming. We anticipate a continued bid in the yen as loans in yen are paid off over time, hopefully in a stable way, not in a panic as happened August 5th.

The Chinese renminbi/yuan is the other wildcard here. The Chinese government has been reluctant to let the currency move downward, afraid that a lower yuan will cause more inflation for the Chinese populace (which it probably will). But their keeping the yuan at or near current levels makes it much harder for the economy to recover; the financial system needs to liquidate bad investments and restart investment and, thus, growth, which is usually done with a lower currency and increased sales due to lower prices and, thus, better competitiveness. We shall see if the Chinese can do this because it inevitably leads to some in power losing everything. But this is a situation that could affect world exports radically in 2025 as the Chinese deal with their struggling economy while trying not to anger incoming President Trump with lower prices and growing export market share needed to help bring China out of recession.

Bottom line: The US dollar has been very strong, but history points toward it possibly weakening under the new administration. The yen could appreciate going forward but betting on the BOJ to move has been a losing proposition for years. The Chinese don't want to devalue their currency, but they may be forced to do so to try to kickstart their economy. The euro is weak, and the large European countries are tipping toward recession, making the euro unattractive. We don't see any attractive trades in currencies at this time, but we continue to follow them.

Commodities

Last quarter, we wrote in our Investor Letter about how we are at the beginning of a commodities bull market cycle according to a number of investment research pundits. However, we were in a Fed credit tightening cycle as well, which generally acts as a retardant for assets like commodities, which don't produce a yield to compete with many other financial assets.

Having said that, commodities have been rallying in late December and early January as market participants see economies being weak, stocks correcting somewhat and supply/demand situations improve as geopolitical tensions continue to have effects on global trade and supply chains while large economies continue to grow.

Gold, in particular, has stayed strong after a banner 2024 for gains and a month-long correction post the election. Gold has stayed strong primarily from international buying, in spite of a strong US dollar. After Western powers seized the financial assets of Russia held abroad in early 2023, gold has had a constant bid as countries around the world continue to add gold to their reserve portfolios as a hedge independent from the dictates of the Western financial system (including many countries in the West, like Poland). In fact, in the last twelve months, gold prices have risen approximately 35%, far outpacing other assets, including most US stocks.

Even more impressive is gold's performance against bonds, especially US bonds. As the dollar has rallied and bonds have risen in yield, gold should have seen less buying. However, in the same last twelve months, with the dollar higher and 10-year Treasury yields rising 22%, gold, as mentioned above, has risen 35%. This shows investors continue to value gold as a safe haven, like they do US dollar-denominated assets.

Gold is also being used as a substitute for Treasuries, despite its lack of yield, because of the growing concern over the amount of bonds to be issued to cover the now-structural large US government deficits and the growing interest bill, both of which must be paid by additional borrowing.

As this chart from The Kobeissi Letter in a January 16, 2025 entry on X shows, gold has finally reached its inflation adjust highs from the 1970s and is poised to set new highs in the future (as we go to press, gold has exceeded $2,800/oz, setting new nominal and inflation-adjusted highs):

Finally, we stated earlier gold was in a correction, but prices bottomed in late December and have now broken above $2,800, extending the bull move. We continue to like gold and gold-oriented investments in the portfolio, which we think provides protection against out-of-control US debt and deficits, as well as the possibility of a weaker dollar and possible further weakness in US financial markets.

Silver should be acting like "gold's little brother," especially because in the past it has provided many of the same benefits of gold as a monetary holding, while its conductivity makes it valuable in a number of different industrial processes (most notably solar panels), all of which guarantee a constant demand for silver regardless of price.

Silver has been in deficit (demand exceeding supply) for the second year in a row, meaning inventories have been needed to satisfy total demand since early 2023. We think prices will adjust to reflect this tighter supply/demand balance in the near future, and we own silver and silver miners because of their attractiveness.

Bottom line: We continue to think the attractive valuations, increasingly attractive supply/demand characteristics of many commodity markets, and the geopolitical frictions (and added costs) of 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

The Problem with Bonds
And the Effect on All Other Financial Assets

Two financial market titans, Stanley Druckenmiller and Paul Tudor Jones, have posted some of the best trading results by any asset manager. Both have been "at it" for decades, so each have been through a number of different economic times and trading scenarios.

Earlier this fall, both came out in very public ways and declared they hated bonds and not only didn't own any, but each was actively short long-dated US bonds.

Obviously, the US and most other world governments who could borrow when rates were very low (or even negative) did so, and part of the reason that they could is the "regulatory world" where so many governments and pension regulations have made bonds a permanent part of any portfolio, creating a huge number of large buyers. And with central banks performing "financial repression" (keeping rates low and buying bonds to support markets, when needed) after the 2008-2009 financial crisis and in some cases continuing until just recently, bonds have had a natural buyer to "sop up excess supply" while world central banks were fighting disinflation or deflation from globalization during the 2010s.

However, conditions have changed now, pointing toward more inflationary forces continuing to percolate through most world economies. To reiterate, in an inflationary environment, bonds lose their purchasing power over time, regardless of how good the credit or interest rate is on the bonds. And when inflationary forces are incorporated into the bond market on a more permanent basis (as we appear to be seeing), bond rates move upward further than before to compensate bondholders for this perceived future loss of purchasing power.

Financial executive and markets pundit David Dredge, who runs financial consulting and hedging firm Convex Strategies, did a November 2024 interview with Grant Williams of The Grant Williams Podcast, highlights this well:

> "I come away with the same thing [in almost every recent conversation] that the thing nobody's protected from is inflation. They're still sitting on the financial repression

element of the [past financial markets with the] misspent belief that bonds were riskless or bonds were risk reducing. And so while I know maybe in certain parts of the world people are piled into equity markets, in the very traditional [financial] world [of] regulated financial institutions, they're still massively owners of all these bonds.

"I mean obviously somebody has to own all the bonds as every major government in the world's blown through 100% of debt to GDP and I happen to know who owns them. They're traditional 60/40 modern portfolio theory [investors], risk parity [hedge funds], … insurance companies, … standard pension funds, … and banks. They own all this stuff and, … if you're a bank, it's [considered] risk-less [for regulatory purposes]. If you're a pension fund, it's [considered] risk reducing. So you can add leverage to it and reduce your risk more.

"And nobody's accounting for the losses. Everybody's vastly familiar with the massive unrealized losses and the hold to maturity books of banks and the numbers get reported every quarter and they just are stuck there. And you go and you talk to people and they're just so comfortable that normal is what we went through, the two or three decades of inflation targeting, price stability, volatility suppressing dynamic and normal is to go back to that. Whereas I think most people who look at a longer time series would say that's one of the biggest, if not the biggest anomaly, in financial market, economic management history, 15 years of zero interest rates and unlimited QE across every major central bank in the world has distorted a data series that only goes back 20 years to look like nonsense in the rest of history. So I'm amazed at the consensus view that status quo is unchanged.

"I don't know [when investment managers will have to start selling bonds], although I guess eventually they will have to because they'll have fund withdrawals. <u>But certainly they've stopped buying, and this is the problem</u>. The [worldwide] bond issuance just keeps growing. And the demand, because you stuffed banks and pensions and insurance companies full to their capacity, they're no longer enthusiastic buyers.

"[Who] is going to buy bonds besides central banks now? Mario Draghi wrote his [European] competitiveness report [that to keep competitive, the European Union needs to] borrow 800 billion euro a year. From who[m]? Because the French are already trying to borrow it and the Japanese aren't buying anymore and the Chinese aren't buying anymore because they're trying to borrow it [too, now].

"[The] unrealized losses and the carry benefit of owning them went away. And you've got global financial institutions, whether they're Taiwanese insurance companies or Dutch pension plans or US banks or whatever they are that are full and they don't want to buy more bonds. And of course Janet Yellen has dealt with that by issuing short-dated bills that households and hedge funds and price-sensitive buyers are happy to buy at a 5.5% previous yield. But she's struggling to issue duration bonds because the holders of duration bonds have massive unrealized losses and very little appetite to absorb more. This problem just keeps building as more [countries look to roll over their debt and issue more to cover their deficit spending]."

Mr. Dredge is obviously worried about the market's huge unrealized losses on their bond portfolios and investors' seeming indifference to it, with respect for their appetite for more bonds. In addition, bond portfolios are "full," generally at their maximum allocations, so the ability to take on additional bond positions is in serious doubt. And countries that have traditionally held onto dollars generated through trade by holding Treasury bonds are not only doing less (Japan, the largest international holder) but either slowly divesting (China) or having totally divested (Russia, formerly a significant holder of Treasury securities at times).

Daniel Oliver, who runs institutional research and management company Myrmikan Capital LLC, recently wrote in his periodic newsletter titled "Liquidity Reversing," January 14, 2025, a good description of how "out of whack" the US Government's bond portfolio is from its more prudent historical allocations:

> "Normally, the Treasury raises between 15% and 20% of the money required for federal government deficit spending by offering short-term Treasury bills (maturities less than a year), the remainder in longer-term notes and bonds. But in Q4 2023, [Secretary of the Treasury] Yellen financed the deficit with a mix of 60% bills; in Q1 2024 it was 57% bills, and 34% in Q3 2024. … Yellen's policy … had the effect of issuing fewer long-term bonds than expected, which supported their prices, creating artificially lower rates in the 10-year bond, which is the reference point for mortgages and other long-term credit. Now Trump's anointed Treasury Secretary Scott Bessent must decide how to roll the $6.7 trillion in Treasury bonds coming due in 2025. He is well aware of the problem, having written about it in his investor letter dated January 31, 2024:
>
> > 'We believe that the Treasury had become uncomfortable with the bond market sell-off to date and the tightening of financial conditions that resulted. As such, even though it would be more expensive to fund via Treasury bills given the deeply inverted yield curve, the Treasury decided it was a price worth paying. Over the short-term, this change in issuance strategy has had the desired effect, with financial conditions easing materially since the November 1 announcement. However, over a medium-term horizon, we believe this is a risky strategy, and it comes with significant costs. In addition to a higher interest expense, concentrating issuance in short tenors exposes the Treasury to greater volatility via refinancing risks and creates the potential for a financial accident.'
>
> If Bessent reverts to standard Treasury practice, issuing only 15%-20% in bills, the 10-year financing reference rate will [move] higher [than it otherwise would have]…"

Thus, Mr. Oliver points out that 10-year Treasury rates will have extra pressure on them as the Government has to "over-issue" them, compared to T-bills, to try to get the mix of Treasury debt to a more prudent balance. This is bad news in an already oversupplied market with international and corporate competition for issuance as well as a new administration that would like lower interest rates so that mortgages and other debt-financing is easier for the nation's populations.

One further point: the world's population is aging, at least in developed countries where the majority of the wealth is concentrated. Generally, older people will need more current income and investment

stability for their peace of mind and lifestyles, pointing to a bond-centric portfolio. However, this portfolio allocation is formulated with stable prices and governments in mind, as we've had for the most part since World War II. However, recent fiscal and monetary policy has kept the US economy running hot, using borrowed money to expand at will, with monetary authorities keeping interest rates low and buying bonds when inevitable imbalances ended up causing financial upsets, allowing "the game" to continue. This behavior has now led to so much spending and expansion that inflation has unanchored prices and the government has borrowed so much that it is starting to "crowd out" private borrowing, as evidenced by interest rates above 10% for less creditworthy companies and individuals. And this same behavior has happened in most countries in the developed world.

So, seniors who should have been able to construct and live on a ladder of bond investments and make it last throughout their lifetimes are no longer able to depend on this strategy working: inflation eats away at purchasing power limiting the ability to maintain one's lifestyle over time. Meanwhile, too much debt means the creditworthiness of bonds in aggregate is lower, meaning there could be safety issues in bond portfolios. Thus, seniors are increasingly needing to have non-fixed income investments in their portfolios to fight inflation and avoid bond defaults, cutting down further on the demand for fixed income instruments at a time of increasing supply.

Bottom line: we are very concerned about the amount of debt outstanding and the ability to place that debt going forward, with the large deficits virtually locked into world government budgets currently. Throw in the lack of investment in infrastructure that must be replaced to maintain world societies, coupled with lack of workers' wages to keep up with prices over time, and we are looking at continued inflationary pressures, limiting the ability for world central banks to use the same monetary policy that rescued economies around the world since the 1980s, which if continued, will lead to accelerating inflation. To paraphrase Bill Fleckenstein of Fleckenstein Capital as he has said for years in his "Daily Rap" blog: "At some point, the bond market will take away the printing press from the Fed." It appears that such a moment approaches, and if it does, we will be able to see it through a couple of tells; either there will be: 1) a failed government bond auction (where the central bank has to buy the rest of the government's bonds because not enough private buyers bid) or 2) a rapid rise in longer-term interest rates as bond issuers have to incentivize buyers with lower prices (and thus higher yields) to place their bonds. This kind of situation could lead to another financial crisis, so we are keeping our eyes peeled to make sure we see these types of situations developing and try to sidestep as much of the fallout as possible. We also keep these concepts in of our investment process to help shape our defense against such occurrences, like investments in gold, oil, other commodities and other hard assets.

Last point: In the case of an equity downdraft, we could see a "flight to quality" to bonds as happens when investors get scared about owning too many equities and in risky situations. As talked about by Mr. Dredge near the beginning of this commentary, most investment institutions are "full" of bonds by their investment policies and mandates. They will probably be allowed to buy more in a financial panic, but afterwards, they will be even more "full," and the subsequent selling of bonds could cause a renewed financial crisis as buyers could be nearly impossible to find.

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