KANOS
CAPITAL MANAGEMENT, LLC

Fourth Quarter 2012 Investor Letter

Portfolio Comments

We made minimal changes to our portfolios this quarter because we have setup our portfolios to take advantage of the Federal Reserve's money printing, which was increased in both the third ($40 billion/month) and fourth ($45 billion/month) quarters. With a portfolio of attractively-valued stocks, some stock market index hedges and cash, we felt that our portfolios were positioned well for the events of this quarter. While investing always involves uncertainty, this quarter contained a number of exogenous (non-financial market) uncertainties: the US elections, the subsequent negotiations to tackle the "fiscal cliff", the Fed's December meeting dealing with the end of "Operation Twist", and the ongoing saga of Europe and its bailout negotiations.

In spite of our preparations, our portfolios did not perform as expected due to the markets' near disregard of the fiscal difficulties in the US, Europe, Japan and much of the rest of the developed world. Some positions including our weaker yen and forestry products investments performed well, but our precious metals, energy, agricultural and pharmaceutical positions, after a strong third quarter, suffered during the fourth quarter. The complacency which often accompanies dampened volatility, reappeared and led traders to shed more defensive positions like metals, energy and pharma stocks in order to redeploy into growth/momentum stocks that had outperformed during the year.

Why? Our analysis has been correct: we were proven to be right in recognizing that the US economy had not recovered last spring, we correctly anticipated that Federal Reserve Chairman Ben Bernanke and the Fed's Open Market Committee would be forced to institute more quantitative easing (QE3, which was announced in September and QE4, which was announced in December) and we predicted that Europe would stay weak and that Japan would be forced into more quantitative easing (the landslide December election in Japan guarantees this will happen in early-to-mid-2013).

And yet, markets have not responded in the way we expected. QE3 and QE4 have been slow in implementation as the Fed committed to purchases starting in September but actually began buying the bonds starting in December. Meanwhile, the Fed's (and US government's) support efforts for the US financial industry have cemented in investors' minds the virtual certainty of the "Bernanke put", in which market participants believe that the Fed (and the US government, through the Treasury Department) will support asset prices and act as the safety net for the financial system. The implications of this are now apparent to us: traders and financial institutions believe that QE money can be used to invest in the stock markets with less risk due to the lack of competition with bonds (they yield almost nothing) and the support of the Fed's almost guaranteed ongoing stimulus.

This mentality has translated into rallies in the following groups: 1) *growth stocks*, regardless of current profitability, where these companies' growth prospects will be realized in future years' profits or from takeovers, both of which are not at all certain; 2) *larger multi-national blue chips*, because they generally yield more than bonds and the companies underpin the US economic system and will find Fed and government support if threatened by financial crisis; and 3) *financials*, because they are

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deemed to be needed by the US economy to keep functioning and grow in the future and are the direct beneficiaries of zero interest rates (which they can invest at the Fed for a 10-15% risk free spread or in US Treasuries for little risk besides duration). Unfortunately, what is not judged to be currently needed in portfolios are traditional stores of value, such as resources in the ground. While more muted, this is a rebirth of the mentality of the late-1990s (when technological changes combined with easy Fed policy to form the Internet bubble) and the mid-2000s (when low Fed rates and the emergence of East Asia led to the housing/financial bubble which popped in 2007-2008). Stock valuations today, while not historically far overvalued, are aggressive, especially when judged against economic prospects around the world (slow growth or recession in the developed world, more subdued growth in the developing world), geopolitical concerns (US politics, the European "mess", Japan/China antagonism, Middle East hotspots and terror concerns) and, of course, the huge debt/entitlement overhang that faces the US and Europe today.

The danger of this market stance is that it presupposes that the Fed and US government are "bigger than the market". While this is usually true in the short-run, **it is usually untrue in the medium-to-long-term.** This is especially true when it comes to the implications of inflation, which is still thought to be months or years away (when it is actually already happening – think food, energy, education, insurance, etc.). Thus, when this market mentality reverses, the market will again look to more traditional measures of value, which is where much of our portfolios are positioned. We will examine more of the implications of this market stance in the "Going Forward" section below, but we believe that is the position of markets today. **Meanwhile, we will continue to manage our portfolios to capture value while not succumbing to the "siren song" of outperforming equities with elevated risk and stretched valuations.**

Before covering the quarter's review, we would like to help people understand our thinking around our contrarian positions, which we think are summed up masterfully in the January 2013 Oaktree Capital Management Client Letter by Chief Investment Officer Howard Marks called *Ditto*, in which Marks describes the attributes and process of being a successful contrarian:

> "To be a successful contrarian, you have to be able to:
> - See what most people are doing;
> - Understand what's wrong about most people's behavior;
> - Possess a strong sense for intrinsic value, which most people ignore at the extremes;
> - Resist the psychological pressure that make most people err; and
> - Thus, buy when most people are selling and sell when most people are buying.
>
> **And one other thing: you have to be willing to look wrong for a while. *If* the herd is doing the wrong thing, and *if* you're capable of seeing that and doing the opposite, it's still highly unlikely that the wisdom of what you do will become apparent immediately. Usually, the crowd's irrational euphoria will continue to take prices higher for a while – possibly a long while … the contrarian will appear wrong, and the fact that his error comes in acting differently from most people will make him look like nothing but an oddball loser. *Thus, in addition to the five requirements listed above, successful contrarianism requires the ability to stick with losing positions that, as [iconic Yale***

> ***endowment manager] David Swenson has written, 'frequently appear downright imprudent in the eyes of conventional wisdom.'"*** **[Emphasis ours – KS]**

We believe our portfolios are well-positioned for an environment dominated by central bank currency creation and suppressed interest rates; our positions should be outperforming, and we believe they will do so in the first quarter of 2013 and for at least the next couple of years. The markets did not favor value investments in 2012, although our portfolios performed very well during the post-election drop in markets and during the days of extreme weakness during the "fiscal cliff" negotiations in December. However, market sentiment should help make our portfolios more profitable in 2013 regardless of the way sentiment moves: if investors see the economy improving, then the extreme monetary stimulus will have them worry about rising inflation, which will benefit our portfolios, and if investors see the economy faltering, they will anticipate more Fed monetary stimulus, which also benefit our positions.

Fourth Quarter Market Conditions

In general, investors during the quarter were more hopeful and bought into recovery-oriented stocks like multinational mega-cap companies, financials and deeply-oversold industrials, ignoring the signs of continued economic weakness in the developed world, and in spite of the election and fiscal cliff. Generally, the US stock markets were volatile, ending roughly where they began the quarter, swooning after the US election but then recovering. One exception was technology, characterized by Apple, which suffered greatly during the quarter as investors locked in gains from earlier in the year and judged profits going forward to be less robust than earlier thought. Bonds were also volatile, ending slightly stronger as "US fiscal cliff" concerns sent more investors to the perceived safety of US Treasuries. International stock markets were strong during the quarter, while European bond markets, the focus of financial markets for most of the year, were quietly strong and mostly uneventful.

October was generally weak after the S&P 500 index's strong 3Q performance. Our portfolios outperformed during the month as investors bought mining stocks as they saw the Fed's QE3 announcement in September to be bullish for metals. Financials were the best performers while technology and telecom were the worst as investors fretted about the upcoming US election and worries about US budget deficits and debt levels.

In early November, our commodity-oriented portfolios outperformed during the 5-day fall in US stocks markets following President Obama's re-election, and our hedges proved to be good protection. Following the early month swoon, stock markets around the world rebounded during the second half of the month as the certainties following the US and Chinese election cycles led to perceptions of rekindling of world economic growth. Bonds, utilities and energy performed the poorest, while most other sectors saw small rebounds after poor October performances. Precious metals underperformed after a number of large miners reported worse than expected quarterly earnings, resulting in the whole sector being sold off during the month. Some of the weakness was also caused by strength in the US dollar index which rose to two month highs before dropping during the latter part of the month. Foreign stocks responded with generally good performances, led by Japan's Nikkei.

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December was full of notable events that affected markets. The Fed had their last meeting of the year and decided to implement an additional $45 billion/month of bond-buying (purchasing long term Treasuries that had been half of the expiring Operation Twist) **for a total of $85 billion per month**. Many had anticipated this decision to implement QE4 but not the accompanying policy decision: the announcement that quantitative easing and interest rate changes would be linked to the US employment rate (with a "trigger point" of 6.5% unemployment) and inflation (a *target* of 2.0% inflation), leaving policy in place until employment was steady at those levels. In a logic-defying manner, although these two policy decisions were bullish for precious metals prices, investors took them to be more bullish for re-establishing economic growth worldwide, and proceeded to buy US stocks and sell metals and mining stocks were sold, since inflation didn't seem to be rekindling (we strongly believe that this sentiment will reverse in early 2013 when the economy stagnates or inflation picks up).

The case for inflation and falling currencies was buoyed during the month by developments in Japan: Prime Minister Noda was forced to call elections, and conservative LDP former Prime Minister Abe and his party won a landslide victory in December, running on a platform of "unlimited" printing of yen, establishing a 2-3% inflation target (instead of an implicit goal of 1% which was not being achieved) and potentially changing Japanese law to make the Bank of Japan answer to the Japanese Government. The election and new policies led to an accelerating weakening of the yen, but did not ignite inflationary fears as worldwide markets took a "show me first" stance. However, Japanese stocks did advance strongly again in December, reflecting reduced uncertainty and a hope for higher exports (goosed by a weaker yen). US stocks were up much of the month, but suffered as the fiscal cliff negotiations went down to the wire, causing uncertainty and tax-selling (to lock in lower 15% capital gains rates). Overall, financials again outperformed, as traders saw them as the prime beneficiary of low-cost money from worldwide central. Housing is thought to be recovering, which would also help the banks by buoying current mortgage and mortgage-bond portfolios as well as by stimulating a renewed mortgage origination cycle. Industrials and materials were flat while all other sectors were down, led by consumer staples, technology and telecom. Crude oil, buoyed by unrest in the Middle East and cold weather in Europe and Asia, confounded many forecasts and stayed relatively strong with WTI closing the month at $91.82/bbl after trading as low as $86/bbl in mid-December. The US dollar, after its early November strength, was weaker for most of December (hurt by political infighting around the fiscal cliff), closing the month under the psychologically important 80 level at 79.88. Long-term bonds were weak during most of the month, but rallied near the end of the month on safe haven buying. The 10-year Treasury ended the month with a yield of 1.76% and the 30-year ended at 2.95%. European stocks followed US markets, rising in price during much of December but suffering at the end of the year due to US political uncertainty. Asian markets, led by Japan (due to the abovementioned fiscal and monetary policy initiatives) and China (improving economic statistics), rose during much of December. Bonds were volatile but ended the quarter at much the same levels as at the end of the third quarter.

Precious Metals

The precious metals didn't hold onto their third quarter gains during the fourth quarter as investors resumed investing in growth stories and for the most part shunned safe havens such as precious metals. Precious metals mining stocks were projected to have breakout third quarter earnings, but while some of the companies did report excellent results, the larger companies, namely Barrick Gold, Newmont Mining and Goldcorp, did not reach analyst expectations, and the stocks were sold off viciously. In spite of these factors, a number of buyers emerged for bullion and stocks, further validating large allocations to precious metals investments: 1) large savvy investors George Soros, John Paulson and Ray Dalio reported upping their precious metals investments when SEC forms showing their positions were released in mid-November; 2) sovereign/central bank buying continued to be strong during the quarter, headlined by the Iraqi central bank's purchase of 25 tons of gold during the quarter, as well as purchases by Korea, Turkey, Brazil and Russia; and 3) some Japanese pension funds made initial investments in precious metals. Pension funds are notoriously slow-moving in changing their investment allocations and they are also known to "copycat" other pension funds once a trend has started. So far, the Okayama Metal & Machinery Pension Fund and two other funds have invested in gold (according to the *Wall Street Journal* on 12/18/2012), and a number of local pension funds last year for the first time allocated 2.1 billion yen, or 2-3% of their assets, in the gold-backed ETF of Mitsubishi UFJ Trust, part of Japan's largest lender (Bloomberg Business News 1/8/2013). We believe this is a watershed event which will lead to more and more pension funds (Asian as well as US and European) investing in the metals and the mining companies. However, the earnings misses of large mining stocks and the rotation to more pro-recovery stocks led to precious metals mining stocks being sold during the second half of the fourth quarter, much to our disappointment.

Energy

Energy prices were volatile during the quarter, as many expected worldwide economic weakness to weigh on oil prices. However, oil rebounded from weakness twice during the quarter with continued transportation demand from Asia and cold weather in Europe and Asia keeping a bid under prices. WTI ended the quarter near its October highs at $92/bbl, while Brent stayed strong and ended the quarter over $110/bbl. Natural gas rose in price during October and early November as a cold fall used more natgas than expected. However, December cold was slow to materialize and supplies proved more than ample to fill storage completely and still be in excess for daily use, causing prices to fall from $4/MMBtu in late November to under $3.50/MMBtu by the time cold enveloped North America in late December. Energy stocks generally underperformed during the quarter as expected lower oil prices weighed on investor sentiment and plentiful natural gas supplies drove investors away from natural gas exploration and production companies.

Bonds

Bond prices weakened during much of the quarter as investors anticipated world growth, helped by central bank monetary stimulus and anticipation of further fiscal stimulus from the Japanese and US governments. Prices were weak in October but rose due to safe haven buying after Obama's re-election in early November and during the fiscal cliff negotiations in late December.

Other Markets

Most international equity markets rallied in October, fell in November and rallied in December, mirroring US markets. European markets led the charge, with the UK market outperforming with a 9.6% gain in October while Japan was the loser of the major indices, falling 4.2% as the persistently higher yen led to smaller exports and high energy prices impacted the bottom line of Japanese companies. However, in November and especially in December, the Japanese Nikkei led all world stock markets higher as central bank easy money policies pushed international stock market higher. International debt markets, like most international equity markets, were higher during the quarter as European debt continued its slow recovery.

Going Forward

Crosscurrents at the end of the 4Q2012 make forecasting 2013 price movements especially tricky. On one hand, US stock markets have been showing an upward bias on any announcement of good news (economic statistics, possible policy resolution, anticipated further monetary accommodation, etc.), leading many to deploy more capital into stock markets as political conflicts take a back seat for the moment. In addition, accommodative monetary policy continues to be bullish for stocks – Japanese stock market gains with Abe's political victory and promised easier monetary policy are just another recent example of this. Thirdly, the yield of equities, when compared to the lack of yield (and danger of default of some sovereign bonds) continues to be a powerful impetus for higher allocations to stocks by institutional pools of capital with high requirements for payout. On the other hand, the problems of the past have not gone away: the world is awash in debt (rising public debt despite falling private sector debt) and deficits; past spending levels, when matched with current tax receipts, are unsustainable, especially when debts have to be serviced. Secondly, central bank easing around the world is shaping up into a series of "currency wars", where easing drives down the value of the currency vis-à-vis other trading partners' currencies, attempting to make exports more competitive. Incoming Prime Minister Abe of Japan said on 12/23/2012, according to *The Wall Street Journal*:

> "Central banks around the world are printing money, supporting their economies and increasing exports. America is the prime example," said Mr. Abe, referring to the Federal Reserve's policy of flooding the market with dollars by purchasing massive amounts of Treasury bonds and other assets. "If it goes on like this, the yen will inevitably strengthen. It's vital to resist this[.]"

Competitive devaluation is expected to make exports more competitive, but commodities traded around the world, such as precious metals, oil, grains and industrial metals, will eventually rise in price as currencies are devalued. Central banks currently don't fear cost inflation brought on by higher commodity prices because they believe that overall demand for goods is slack compared with worldwide productive capacity and that higher input costs won't put upward pressure on more important costs concerns, like wage inflation, anytime soon. We are not so sure this correct, illustrated by the resilience of Brent crude prices (staying around $110/bbl over the past many months) and copper prices (still above $3.50/lb even as the Chinese economy is only slowly emerging from its recent slowdown) as examples of price "stickiness." The purchasing of gold by more and more non-traditional buyers (emerging markets central banks and developed world pension funds) is also a counter-argument against the alleged lack of demand for "high priced" commodities.

Equities

US equities have been outperformers for a number of years since 2009; consequently, companies with top-line growth are valued at bull-market multiples in what many investment managers would consider a time of slow economic growth and unsettled political regimes around world. Stock prices are supported by optimistic forward earnings expectations, continued historically high corporate profit margins, and an expected tailwind from Federal Reserve easy monetary policy for at least two more years. Thus, we are cognizant of continued momentum in investing in US stocks. While historically it may be time to be more cautious, the US stock market has continued in this bull cycle (with notable retrenchments in the summer of 2010 and 2011 and to a lesser extent in July 2012) since 2009 while the ingredients which produced this run (continually falling interest rates, plentiful and cheap labor, more efficient capacity utilization and safe haven status of US domicile) cannot get more favorable than they have been in the last couple of years. Thus, we are concerned about how much higher the stock market can go.

While we like scalable businesses (with reasonable valuations and good yields) like pharmaceuticals, some technology, agricultural businesses and telecommunications, we believe some of the large brand-oriented companies have high valuations and slower growth prospects, leaving them vulnerable to revaluation. However, we also respect the power of the Federal Reserve to continue easy money policies, muting the strength of the US dollar and inducing further asset buying. Thus, we can see equities continuing their 2012 momentum, but we believe that when central bank policies around the world succeed in getting some inflationary traction, our portfolios will prove to be better investments to protect the purchasing power of investors' capital.

Precious Metals

Our performance this year was hurt severely by the underperformance of our precious metals investments. We believe this was primarily caused by the anticipation of higher growth in the US economy, which we believe is too optimistic. The warm winter of early 2012 skewed seasonal factors early in the year, making the economy look like it was accelerating, but it did not. The fourth quarter

rekindled hopes of economic recovery as investors believed a government in virtual gridlock but able to thwart the "fiscal cliff" coupled with a money-printing Fed would raise the financial markets and the US economy simultaneously. So far, economic statistics have not backed up such hopes. One more point: Charles Biderman of TrimTabs said during a recent CNBC interview that the special dividends paid out in December by a number of companies to avoid the anticipated tax hikes have led to more investible cash in January; **however, this cash is merely borrowed from 2013 and will lead to less cash for investment during the rest of the year. These dividends were merely advanced in time, they were not incremental and are borrowing from the future.**

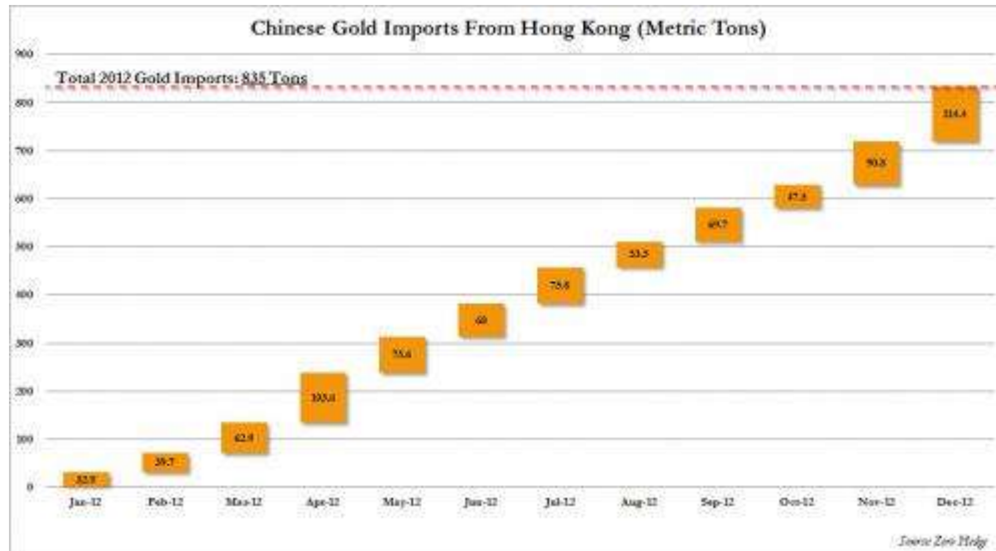
Precious metals and the mining companies continue to have very attractive fundamentals which should be catalysts in 2013 for higher prices. In addition to the long-standing fundamental underpinnings of the twelve-year bull market, which include 1) easy monetary policy and increasing money supply worldwide, 2) negative real interest rates which cause investors to look for stores of value, 3) continuing heightened global financial uncertainty and 4) increasing worldwide consumer wealth and accompanying demand for gold for jewelry and investment, **central banks continue to be large net buyers for the third year in a row**.

In fact, a number of central banks returned to the gold market during the fourth quarter, including Korea (added 14 metric tons in November, adding to its 84 tonne reserves following 16 tonne purchases in July 2012 and November 2011), Turkey (which bought 17 tonnes in October to increase its reserves 5.8%), Brazil (which bought 17 tonnes to increases its gold reserves 48% to 52.5 metric tons), and Kazakhstan (a 7.5 tonne purchase increased its total gold reserves to 111.5 metric tons). The Russian Central Bank bought 19 tonnes in December (or an additional 2.1%) to bring gold reserves to 958 metric tons, according to the IMF website; for 2012, Russian Central Bank gold holdings were up 8.5%, and officials reiterated the fact that they would continue to buy more gold reserves in 2013. In fact, it is expected that central bank gold purchases will exceed the 440 tonnes purchased last year (in aggregate), the highest amount since 1964.

Many see Hong Kong gold imports as a proxy for Chinese central bank gold purchases (which the Chinese keep secret), and it was reported by Bloomberg that:

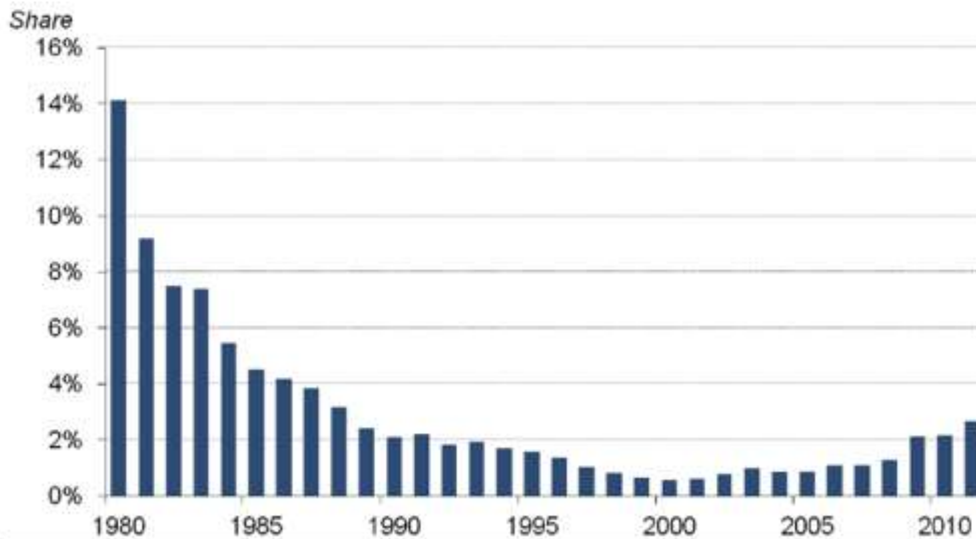
> "[g]old imports into mainland China from Hong Kong surged 94 percent to an all-time high last year as rising incomes in the world's second-largest economy underpinned increased demand and helped the metal to post a 12th annual gain.
>
> "Mainland China imported 834,502 kilograms (834.5 metric tons), including scrap and coins, compared with about 431,215 kilograms in 2011, according to Bloomberg calculations based on data from Hong Kong's Census and Statistics Department. Imports in December rose to a monthly record of 114,405 kilograms, according to data from the department yesterday."

The chart below illustrates how much gold is moving into China from the rest of the world. It seems to be very bullish for gold that China imports are increasing and at a fast pace than last year.



Finally, increasingly loud calls in many countries worldwide in favor of currency depreciation (to bolster global trade or avert deflation) has caused more and more large institutional investors to consider precious metals as a store of value. The recent entrance of some Japanese pension funds to the gold investment arena (see above remarks) marks another milestone in the reacceptance of precious metals into mainstream institutional investment plans. In a related note, The Pacific Group Ltd., a Hong Kong-based institutional asset manager, announced it would convert one-third of its hedge fund assets into physical gold, to be stored at Hong Kong airport vaults. We anticipate that this institutional investment trend will accelerate in 2013 as competitive devaluations, now vocally championed by Japan, will become more prevalent worldwide, causing institutional investment funds to invest in gold (and other metals) to protect a portion of their capital.

The chart below illustrates just how underallocated private equity portfolios are to gold and other precious metals. The chart shows the percent allocated to gold in worldwide private investor portfolios when including global equities and global marketable government debt, but not including corporate or agency debt, money markets, commodities, real estate, hedge funds, or private equity. Just over 2% of the value of equities and government debt are allocated to gold, despite its twelve year bull market and the massive printing of money by central banks over the past five years. For comparison purposes, in 1980 gold investment was on the order of 14% in a time (the 1970s) when there had also been massive money printing to try to overcome economic malaise. We anticipate institutional investment will increase in the next few years to bring gold investment to at least 5%. If those allocations doubled to 5 percent, it would entail investors buying 65,000 tonnes of gold or the equivalent of 23 years of production!



If gold's share doubled, it would amount to c.66,000 tonnes, equivalent to 23 years of production at current levels.

Source: CPM Group, OECD, TR Datastream, Thomson Reuters GFMS, World Gold Council

Energy

Continuing increases in North American oil production and the opening of new Midcontinent pipelines has led a number of analysts to forecast lower oil prices for 2012 – 2013. As of this writing, the anticipated fall has still not materialized as bitterly cold winter weather in eastern Europe and Asia, coupled with increased petroleum usage due to curtailed nuclear generation in many countries, has kept oil demand higher than expected. In addition, Saudi Arabian production has not kept up its torrid pace of 10+ million bbls/day of earlier in the year, meaning supply concerns have kept a bid in oil prices. Finally, money printing by the US, Japanese, Swiss and other central banks has contributed to keeping prices higher as financial market participants continue to eye inflation concerns and keep long positions in oil as hedges against a possible acceleration in inflation.

We anticipate all of these factors will continue, offset at times by demand scares, as the economies of the developed countries continue to sputter. Meanwhile, data showing increases in economic activity in east Asia, led by China, should underpin world demand growth for years to come.

Other Markets

The bond markets continue to look unattractive to us. Yields are miniscule, bonds are a "crowded trade" and we anticipate that inflation, at some point, will hurt bond. Howard Marks of Oaktree (again from his January 2013 Client Letter titled *Ditto*) sums up the bond situation comprehensively:

"**Regardless of the reason, things are happening again today – especially in the credit world – that are indicative of an elevated, risk-prone market:**

- Total new issue leveraged-finance volume – loans and high yield bonds – reached a new high of $812 billion in 2012, according to Standard & Poor's, surpassing by ***20%*** the previous record set in pre-crisis 2007.

- The yields on fixed income securities have declined markedly, and in many cases they're the lowest they've ever been in our nation's history…absolute returns are minimal.

  I find it remarkable that the average high yield bond offers only about 6% today. Daily I see my partner selling callable bonds at prices of 110-115 because their [effective yield to call is] 3 or 4 percent. The yields are down to those levels because of strong demand for short[-term] paper with prospective returns in that range. ***I've never seen anything like it.***

- As was the case in the years leading up to the onset of the [financial] crisis, the ability to execute aggressive transactions indicates the presence of risk tolerance in the markets. ***Triple-C bonds can be issued readily***…

- The amount of leverage being applied in today's private equity deals also indicates a return to risk taking. As *The Wall Street Journal* reported on December 17: 'Since the beginning of 2008, private-equity firms have paid an average of 42% of the cost of large buyouts with their own money, also known as "equity," while borrowing the rest. In the past six months, the percentage has fallen to 33%, according to Thomson Reuters, close to the 31% average in 2006 and 30% average in 2007…'

The good news is that today's [fixed income] investors are painfully aware of the many uncertainties. The bad news is that, regardless, they're being forced by the low interest rates to bear substantial risk at returns that have been bid down. **Their scramble for return has brought elements of pre-crisis behavior very much back to life…Please note that my comments are directed more at fixed income securities than equities**…Equities are still being disrespected, and equity allocations reduced."

Like Mr. Marks, we believe that fixed-income provides a lot of risk for very little reward, and that investors chasing yield have driven bonds up to levels that could prove dangerous for return of capital.

The Economist's Buttonwood columnist writes that many now believe there is a "Bernanke put" on US Treasuries, which is probably widely believed. However, a comment on Bill Fleckenstein's financial blog probably sums up best why this notion is erroneous: "The whole idea of a "Bernanke put" on government bonds is ludicrous. **He is keeping their price up by buying them, but by buying them he is insuring that there will be inflation which will drive their price down**. ***[Emphasis ours – KS]***

In Europe, the bond markets were relatively stable during the quarter, leaving many to believe the worst was behind the EU and the ECB. However, the Eurozone is in recession. Meanwhile the euro has been gaining against the US dollar, which could cause further weakness as exports become more and more expensive due to currency differentials. The social (and probably political) crises are probably still years away from resolution, and we believe that there will be continual financial hiccups that accompany the resolution of the social and political upheavals to come.

Kanos Quarterly Commentary

A Long View

We are often asked where we think financial assets are going. While no one knows how world political, economic and social events will effect markets, we believe that relying on historical examples, human tendencies and financial market trends can help us position your portfolios for long-term wealth enhancement.

Thus, as we've said many times in the past, we examine the world macroeconomic landscape, look at countries' financial markets, asset classes and investment sectors, and try to pick attractively-valued companies that we believe will yield above-average investment returns in the future.

While the investment markets have shown some volatility in 2012, there has been a relative calm and almost stasis to the markets since mid-summer; most financial assets are within a couple of percent of where they have been at various times throughout the fall. There are some notable exceptions (Apple and the Japanese yen, for example), but for the most part, even after the elections in the US and France and new leadership in China, financial markets have seemed to be extremely "well-behaved". Maybe it is the continued worldwide monetary easing that buoys market (certainly a big influence). Maybe it is the confidence that the US fiscal cliff and European Central Bank assistance for financially-strapped countries will ultimately succeed (definitely an influence). Maybe it is the belief that the world will start growing as the deleveraging which began in 2007 starts to wind up, underpinned by stimulus by some governmental spending around the world (also an influence).

However, we believe that there are some longer-term trends which will affect financial markets over time – although we cannot be sure when each will assert itself or when its influence will increase. These are our most compelling ideas we believe will dominate our future investment decisions:

1) The Japanese are in a fiscal and demographic crisis that is virtually unsolvable at this point, and the yen must fall in value over time because of these factors

The Japanese face a number of serious problems (some would say terminal problems) with which they must grapple going forward: 1) debt and fiscal deficits, 2) demographics/lack of immigration, 3) balance of payments/lack of natural resources, 4) export based economy/trouble with China and 5) chronically weak governments.

These influences have been obvious for some time, and yet the financial markets have not reacted to them by pushing down the yen and raising Japanese interest rates. Why not? Mostly because the historical savings rate – the Japanese made so much money over the years and saved it in both domestic and international investments. In the last two decades, as Japan has aged, its population has moved its investment to more age-appropriate investments: domestic bonds. This capital flow has kept Japanese bond prices high (as seniors locked in yield and price stability for their sunset years and Japanese stock prices low (as investments were sold) but has also reflected the diminishing returns in a moribund economy. The Japanese yen has stayed strong as these savers moved capital from overseas investments back to Japan, selling overseas holdings and repatriating these investments by purchasing yen.

Now that strong yen is affecting the economy. The 1980s bust in Japan led to falling asset values in the 1990s/2000s that has led to slow growth/recessionary economic conditions since then. Japanese governments, unwilling to admit failures of the past, have supported insolvent banks and uncompetitive companies through fiscal stimulus and low interest rates for more than 20 years. This stimulus and resulting stagnant output has led to continuing government budget deficits. Also, "zombie" companies, while continuing to employ people, have not contributed much to economic growth. Thus, the combination of government deficits and sputtering economic activity has led to Japan having by far the largest amount of debt (estimated at 230% of GDP) in the developed world. Incoming Prime Minister Shinzo Abe has promised to rectify this situation through larger stimuli and a lower yen. He believes this approach should stimulate exports and help the economy grow again. We have a hard time believing the Japanese economy can withstand the negative forces of such a big debt burden, especially if one layers more inflationary forces (one aim of the creation of much larger quantities of yen in order to weaken it) into the mix.

Meanwhile, the demographic forces facing Japan are approaching a catastrophic situation. The Japanese populace ceased reproducing at a self-sustaining rate more than two decades ago, and its current fertility rate, estimated at 1.39 (according to World Bank estimates) is forecast to lead to **a halving of the population** within 70 years. If this weren't bad enough, Japan has historically considered its culture to be superior to all others, and thus their immigration policy has been virtually non-existent. Therefore, lower-wage workers from other parts of Asia, used extensively throughout the rest of the world as low-cost efficient labor, are little used in Japan, leading to even more difficult future demographics for providing support, both monetarily (through taxes or charity) and bodily (providing physical care) for the fast-aging Japanese population. For all intents and purposes, the Japanese are moving past the point of ever arresting this decline in population.

One of the factors that sustained Japan for so long was its balance of payments surplus, resulting from efficient Japanese industry transforming raw materials into high-quality, high-margin products that reaped large profits for Japan. As a stronger yen has taken its toll on export volumes, three factors have helped worsen the balance of payments to the point that is has recently turned negative: most importantly, energy policy – triggered by the Fukushima earthquake/tsunami which caused the destruction and resulting radioactive contamination at the Fukushima nuclear power plant. This catastrophe led to the shuttering of Japan's entire nuclear fleet, cutting 30% from the country's power supplies. The deficit had to be made up by fossil-fuel powered electric generation, which has caused

Japan to have to buy incremental fuel in world petroleum markets since Japan has few natural resources and no petroleum reserves to speak of. The resulting higher price of energy has largely contributed to the balance of payments deficit. The higher yen has also contributed to this imbalance, as the expensiveness of the yen led to less competitive world pricing for Japanese products, leading to lower export volumes. The final reason is recent political tensions with China; the Chinese are estimated to account for 20% of Japanese exports, and rising tensions over disputed Diaoyu/Senkaku islands offshore both countries (that are believed to contain large oil reserves, as yet undeveloped) has led to a Chinese boycott of Japanese goods, cutting export volumes. We believe this balance of payments deficit is the most compelling reason for change in Japan – the eroding cash position has led Japan to demand changes from its leaders.

Japan has chronically had weak governments that moved policy incrementally over the years when more bold policy would have been needed to change behaviors. Thus, as the Japanese Central Bank has tried to defeat ongoing deflation through its own version of quantitative easing (usually in concert with the Japanese Government's Ministry of Finance), the steps have been incremental and small, and the markets have generally not taken them seriously. This has rendered most policy change initiatives ineffective.

So, all of the above factors have come to a head and have resulted in the election of a new government, with former Prime Minister Shinzo Abe winning in a landslide in early December. He campaigned on a platform of "unlimited yen creation" [shades of the Swiss National Bank] to defeat inflation, targeting a 2% inflation level and accompanying fiscal stimulus to help Japanese industry restart economic growth. His influence on the Bank of Japan is already large: in its January 2013 meeting, the BOJ formally adopted the 2% inflation target and **<u>announced a very large $144 billion (¥13 trillion) per month in quantitative easing</u>** to starting in 2014.

We believe the investment implications are as follows: 1) for as longs as Abe's policies are in place, the yen will be worth shorting, because the government/central bank can easily weaken a currency by printing more and more – this is our primary investment position: <u>short yen</u>; 2) while the policy is in its early stages, especially with a suddenly weaker yen, Japanese industry should show growth and stock prices should go up – this is our secondary investment position: <u>long Japanese stocks</u> (important: with the currency exposure hedged away); and 3) <u>owning resource stocks with exposure to Japan</u> – they will continue to need raw materials (especially energy) to support their export-oriented economy, and the produced inflation should increase the valuations of resource-rich companies.

2) Central banks will continue with an easing bias until they are forced by outside forces to change their behavior.

While this seems obvious, financial markets still react to economic statistics released daily and adjust prices of precious metals, bonds, energy commodities, financial stocks, etc. as if reported economic statistics will alter central bank easing programs. We see this "caution" by financial markets applied selectively, with financial assets rising seemingly endlessly (as of January 2013) while physical assets still show little appreciation. We believe the caution around investing in physical assets will

evaporate over time as more and more easing occurs and the deflationary effects of deleveraging are shown to have ended.

However, caution currently still exists, as illustrated by the early January release of the minutes of December's Federal Reserve Open Market Committee meeting; the minutes reiterated that there were some members opposed to continuing the Fed's quantitative easing – the release of the minutes caused some financial assets, including precious metals, to drop in price due to concerns that monetary easing might be reined in during 2013. **However, subsequent analyses of when the US unemployment might reach the target of 6.5% (using Fed data) showed that estimates ranged from 3 – 7 years, meaning the Fed's own target implied continued quantitative easing through 2015 and possibly to 2019! [CNBC and Federal Reserve analyses from January 2013]**

In direct contrast to the markets' caution over possible Fed tightening during 2013, in a January 13, 2013 Reuters article entitled "*Fed easing may not be aggressive enough: Kocherlakota*" reported by David Bailey, Minneapolis Fed President Kocherlakota argues the opposite:

> "The Federal Reserve's policy of zero interest rates and asset purchases is appropriate, perhaps even insufficient, given forecasts for weak economic growth and low inflation for years to come, [and] [t]he U.S. economy will continue to expand too slowly over the next two years to bring down unemployment substantially, said Narayana Kocherlakota, president of the Minneapolis Fed… Inflation will run below the Fed's target of 2 percent over the next two years and the unemployment rate will remain elevated. This forecast suggests that, if anything, monetary policy is currently too tight, not too easy," he told a meeting sponsored by Minneapolis Fed."

Thus the US Fed seems to not only be instituting QE4, but may maintain such accommodation for much longer than some market participants believe. The US stock markets has seemingly taken this ongoing stimulus to heart during late December-January as the markets have moved up with very little correcting action. The senior membership of the Fed (including Chairman Bernanke, Vice-Chairman (and rumored future Chairman) Janet Yellen and New York Fed President Bill Dudley) firmly believe that the wealth effect caused by the stimulus of quantitative easing will help foster economic growth through trickle-down effects. Even with opposition within the Fed, their belief in this thesis seems to be as strong as ever, and we believe that the Fed will continue with the stimulus until market conditions force them to change.

Meanwhile the Swiss National Bank (SNB), in trying to keep the Swiss Franc competitive with the euro in order to keep Switzerland's export industries competitive, has been, according to a January 8, 2013 story in *The Wall Street Journal*:

> "printing and selling as many Swiss francs as needed to keep its currency from climbing against the euro, wagering an amount approaching Switzerland's total national output, and, in the process, turning from buttoned-down conservative to the globe's biggest risk-taker.

> "Switzerland's virtue is the root of its problem: broad confidence in the Swiss currency and economy has investors hungry for francs to escape euros, the currency of its shaky European neighbors. Such demand makes francs more expensive and, in turn, drives up the price of Swiss exports.
>
> "In the past three years, the Swiss National Bank has printed francs to buy euros and other currencies **in a swelling portfolio of foreign assets four times what it was at the beginning of 2010.** ***[Emphasis ours – KS]***
>
> "Nearly every major central bank is buying nontraditional assets to resurrect domestic economies in the wake of the worst global recession in 75 years. The U.S. Federal Reserve is buying mortgages; the European Central Bank is making unusually long loans to banks; and the Bank of Japan is buying real-estate investment funds.
>
> All risk losing money, but Switzerland's exposure stands out in character and scale: Its central bank is buying assets from other countries and **its holdings of currencies, bonds, stocks and gold – nearly 500 billion Swiss francs, about $541 billion – are nearly the size of the nation's gross domestic product. In contrast, the Fed's buying of bonds and mortgages amounts to about 20% of U.S. national output, and the European Central Bank's holdings stand at 30% of total GDP."** ***[Emphasis ours – KS]***

The Swiss have ignored any collateral damage of pegging the Franc (such as the risk of rising inflation), intent on keeping their export industries competitive. This is in direct contradiction of the Swiss banking credo of the past few hundred years, in which Switzerland treasured its reputation as a banking center (in fact, probably the world's most secure banking system). Now, its banking has receded from world prominence, and Switzerland's exports make up 50% of its GDP and include pharmaceuticals, medical products, watches, and jewelry. Most importantly, Switzerland's European neighbors make up the majority of its trade partners, and the strength of the franc versus the euro had hurt Swiss industry to the point that the SNB felt compelled to move. We wonder what effect this will have on Swiss lifestyles as inflation is bound to heat up with so many more francs created and in circulation.

As noted, the Japanese are also moving toward a far more accommodative monetary stance (see the previous section on Japan). So, the SNB is another major central bank producing more monetary stimulus (on a potentially "unlimited" basis – their words, not ours), which should only add to our thesis.

We believe the investment implications are as follows: 1) for as longs as these policies are in place, invest in assets that will hold their value in times of increasing inflationary pressures – most notably precious metals, hard assets, real estate, some common stocks and even jewelry and art; 2) sell (or at least underweight) assets that could suffer under increasing inflation – such as cash, bonds and especially bond funds; and 3) invest in situations where you can leverage growth and price appreciation caused by inflation – namely growing energy companies and mining companies with large promising undeveloped resources.

3) The costs of extracting resources from the ground are going up while the ability to find large bodies of resources is going down – at some point, this must translate into far higher resource prices.

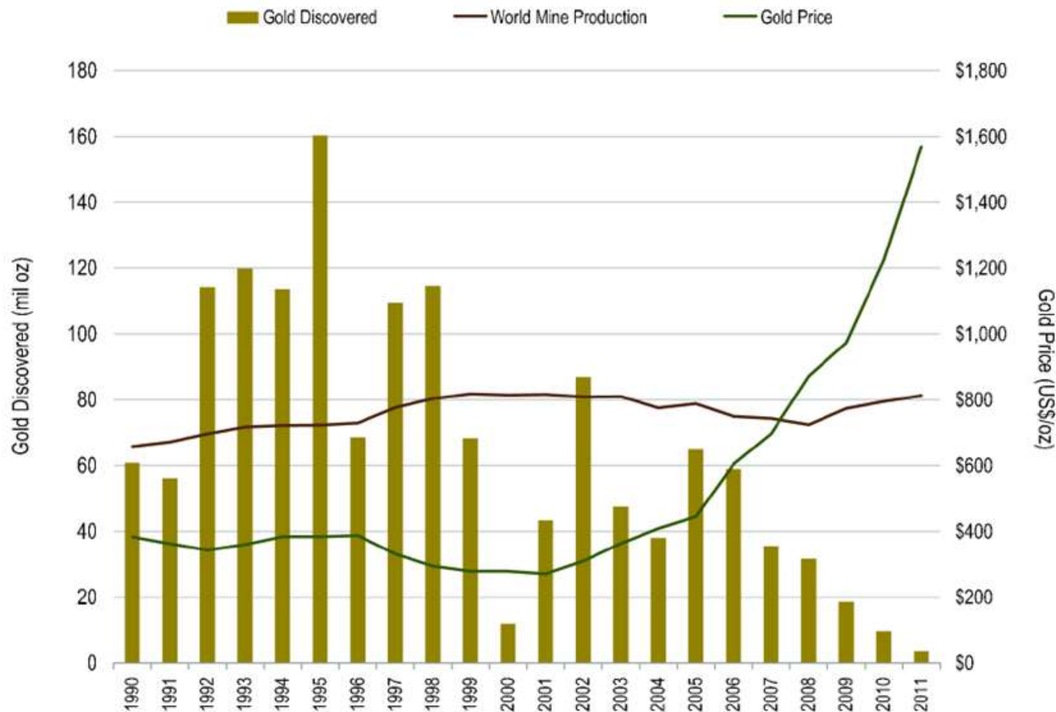
While many would argue resource prices <u>are already</u> up appreciably from historical norms, we believe that the combination of incipient world inflation and the relative rarity of a number of key commodities will lead to far higher prices in the future.

Many commodities are plentiful but a number are actually quite rare in the earth's crust. The ones that interest us are either commodities that drive economies or have traditionally been stores of value.

The most important commodity for our world is crude oil. Its energy delivered per unit makes it an ideal motor fuel, and in spite of prices on the historically high side, worldwide demand continues to climb despite currently declining demand in the US and Europe. Demand has driven prices to remain above $80/bbl for West Texas Intermediate (or WTI, produced in the US Midwest) and $100/bbl for Brent crude (produced in the North Sea and the worldwide benchmark crude for light sweet crude oil), defying many forecasts of dropping prices. Part of the reason for higher prices is the relative lack of light sweet crude oil around the world compared with gasoline and diesel demand. But the main driver is the much more expensive and difficult to produce areas of production. Large onshore fields in the United States, Russia and parts of the Middle East have been depleted and produce much smaller volumes. Large legacy fields in the Middle East and Latin America appear to have "peaked" in their daily production volumes, although reserves of much heavier, sulfur-laden crudes, much more difficult and expensive to refine into light fuels such as gasoline and diesel, are still available for times of peak demand. The oil shale "revolution" in the United States has led to a revival in production in the Midwest, which when combined with pipeline constraints has led to the discounted price of WTI to Brent (although it is higher quality). Some analysts question the longevity of the production revival from shale due to the well characteristics of high initial production dropping to a small fraction of the volume within months – this has been observed by the peaking and subsequent decline of oil production in Montana, where the Bakken shale production first started. Of course, inevitable depletion of oil fields worldwide drops conventional daily oil production by 3-9% per year (depending on whether production is onshore 3-5% or offshore 5-9%) and shale well production in years 2-3 as much as 90+%. More and more oil must be discovered and produced each year to even maintain current levels of demand; 5% of the 88 million bbls/day is 4.4 million bbls/day which must be brought online **<u>each and every year.</u>** We believe replacing production will prove more difficult and expensive each year.

Gold is also a commodity used worldwide as a store of value because it is so rare. For example, all of the gold every mined if combined into a cube would measure 68 feet per side and fit into two Olympic swimming pools – that weighs a total of 171,300 tonnes. The United States Geological Survey (USGS) estimates production has averaged between 2,500 and 2,800 tonnes/year in recent years, thus showing little growth. In addition, costs of mining have risen appreciably in the last decade, as fuel and labor costs (the two largest components of the costs of mining) drag mining costs higher – metals

consultancy GFMS estimates the average "all-in" cost of extracting gold at $1,044/oz. in 2011, up from approximately $300/oz. in 2001.



Demand for gold is also expected to continue its recent yearly uptrend. GFMS projects continued central banking purchases, combined with increased investment demand and flat jewelry demand, will boost prices 6% this year. The combination of limited (economic) new supplies, rising costs and climbing demand shows the value of proved and probable reserves <u>which currently sell in the market in the form of large mining company reserves for as little as $200/oz. currently</u>. We believe these reserves will generate an attractive return with a $1,650/oz. realized price and $1,100/oz. "all-in" cost in 2012/13. If prices rise above $2,000/oz. in the next year or two, margin expansion could make these companies many more times more valuable due to the leverage of proved reserves and rising

Copper is another essential commodity which is prized for its electrical and thermal conductivity as well as its ability to be easily shaped because it is so ductile. While copper is widely spread throughout the world's crust, only extensive concentrations are economic to mine, such as those found in Chile (the world's largest supplier), the United States Southwest, Indonesia, Australia and Peru, to

name the largest producers. According to USGS, copper discoveries peaked in 1996, although production has crept up for the last few years (estimated to be approximately 16 million tonnes in 2011). However, as production has increased, demand (even after the financial crisis of 2008/9) has kept pace and kept copper prices above $3/lb. for the last couple of years, including during the "growth scare" surrounding the Chinese economy during 2012. While we believe there is plenty of copper to be recovered, this production comes at higher and higher costs, as the larger accumulations readily exploitable have been used up and higher, further away, more difficult to recover prospects will become the more costly mines of tomorrow. This should pave the way for higher prices and make current mines very valuable in our inflationary future.

Final point – the increase in power by the Democratic lawmakers in Washington DC and their allied environmental movement has brought another significant factor to resource extraction/pricing – the ability for mining prospects to be blocked by environmentalist stonewalling via protests or pressure on regulatory authorities to not issue permits needed to start mining. Examples of high profile protests/campaigns dogging large projects include: the Pebble Project in Alaska proposed by Northern Dynasty Minerals and the Rosia Montana Project in Romania proposed by Gabriel Resources. Pebble is opposed because possible pollution from the site could contaminate nearby Bristol Bay and the fish populations of the streams and bays near the project; Northern Dynasty has proposed a number of remedial measures to protect against accidents at the 30+ million oz. gold and 18 billion lb. copper deposit, but opposition seems to have tabled development of the project for many years. The Rosia Montana site has been mined (poorly) for decades and is desperately in need of environmental cleanup – however, opposition to further mining includes locals, environmentalists and even George Soros and neighboring Hungary, fearful of further pollution from the site. Of course, most of us are familiar with the environmentalist and Hollywood opposition to further development of Canada's oil sands, as evidenced by the protests against the Keystone XL pipeline last year and the ongoing protests during construction of the pipeline's approved southern leg. These arguments favor accumulation of companies with current long-lived reserves that to us are still trading at "bargain basement" prices. ***We believe the investment implications are as follows: 1) <u>petroleum companies with long-lived conventional reserves</u> should be accumulated since their finding costs will ultimately prove very cheap (oil sands companies are good examples); 2) <u>precious metals miners with large proved and probable resources</u> should prove to be very good bargains at their depressed valuations – in spite of our current overweighting of these companies, extreme undervaluation could be a reason to accumulate even larger positions in solid operating companies; and 3) <u>large base metal mining companies with long-lived reserves,</u> which we think will achieve their higher valuations during inflationary times, should be accumulated on weakness.***

These are our current best long-term ideas that will drive the majority of our future investment decisions. While a couple of these ideas are out-of-favor, the companies that we propose to buy or maintain as investments are currently extremely cheap and attractive to us for further investment. Large changes in world events could change our outlook, but we believe that these trends are well-entrenched and will lead to significant investment returns for years into the future.

The Managers of Kanos Capital Management
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