KANOS
CAPITAL MANAGEMENT, LLC

Fourth Quarter 2013 Investor Letter

Portfolio Comments

We are sure glad to see 2013 in the rearview mirror. It was a year when expensively-valued stocks got more expensive and cheaply-valued stocks got cheaper. We participated in a number of investments that showed good investment gains, but our performance was dragged down by the extreme underperformance of our materials positions. We feel more than ever that the recovery from the "Great Financial Crisis" (GFC) has been anemic all along, and that the extreme outperformance by the stock market will have to be reconciled to the weak economy at some point. Pimco analysts in December estimated that 75% of the rally in 2013 was due to multiple expansion, which means P/E multiples went up to more expensive levels, while only 25% of the rally was based on higher corporate earnings per share. With all of those thoughts in mind, we have increased our market exposure during the year, but we have been unwilling to get more aggressive due to tenuous stock market valuations.

Fund manager and former economics professor John P. Hussman, of the Hussman Funds, sums up our dilemma in his 12/23/13 Weekly Market Comment:

> "Part of a good investment discipline is, and must be, to constantly seek improvements and address challenges. But part of a good investment discipline is also to recognize those points where discomfort is an unpleasant necessity. An "improvement" that might ease discomfort by reversing our presently defensive stance, but that would have left investors vulnerable to the deepest market losses on record, is no improvement at all. We tolerate the frustration of remaining defensive during this speculative advance because it shares hallmarks that were shortly followed by the most punishing market losses in history. **The fact that a similar consequence has been deferred in this instance does not convince us that it has been avoided *[Emphasis ours – KS]*.**"

Kanos far outperformed markets with our investment in Japanese stocks and our short positions against the Japanese yen. Our large US industrial and technology holdings performed in line with the markets. Gold and silver had very disappointing losses during the year as investors decided that large-scale stimulus by US, European, Japanese and Chinese central banks would not lead to immediate inflation and loss of purchasing power. Precious metals mining equities, leveraged to the price of the metals, performed most poorly as profits diminished due to lower price realizations. Energy and other commodity stocks underperformed the market, in spite of high crude prices during much of the quarter.

We have spent a lot of time this year searching for new opportunities to expand our market exposures. The problem is that 2013 valuations compare most closely to 1929, 1973, 1987, 1999 and 2007 levels,

using Robert Shiller's 10-year cyclically-adjusted price/earnings multiple methodology, all of which are years that either contained or were just prior to large stock market losses. We are continuing to comb interesting investments and are trying to find the right timing to enter them while keeping an eye on risk and evaluating the rewards and risks of our current positions. Obviously, we felt 2013 was a large anomaly, and we anticipate a much better 2014. However, we are not averse to changing our market outlook when conditions dictate – so we could sell a number of our current positions if conditions change.

Fourth Quarter Market Conditions

October markets continued the weakness of late September as the US government was shut down due to the lack of an agreement on a budget solution and an impasse over the approaching US government debt ceiling. The S&P 500 dropped to the 1650 level and the Dow Jones Industrial average fell under the 15,000 level in mid-October until a compromise was reached, and then US stock markets took off, and the S&P 500 finished with a total return of 4.60%. Most S&P sectors were strong, led by the Industrial, Consumer Staples and Telecommunications sectors while the Financial, Energy and Utility sectors lagged. US Treasuries, after falling to a 2.65% yield on the 10-year at the end of September, rose as high as 2.75% during the shutdown crisis, but once the compromise was reached, yields plummeted to 2.51%, ending the month at 2.55%. High-yield bonds were the outperformer, barely falling during early October and rising into the end of the month, gaining over 2%. Emerging stock markets benefitted from turmoil in Washington, rising almost 8% during early October, but sold off a bit toward the end of the month, ending with gains of approximately 5%. Precious metals sold off during early October but both the metals and the mining shares followed the stock market higher late in the month, ending with nice gains in both. West Texas Intermediate (WTI) crude oil fell during October after setting multi-month highs during September as curtailed crude supplies from Libya and Iran started to flow more plentifully to world markets.

November was a steadier month, with US stock markets building on October gains after an early month swoon. The S&P 500 returned 3.38% with Financials, Health Care and Technology sectors leading the gains while the Energy sector lagged and the Utility and Telecommunications sectors (typically safe havens) lost money for the month. Precious metals and mining shares were also lower for the month as investors "threw caution to the wind" and plowed money into the broader US markets, taking money away from "safety" investments. Emerging stock markets fell hard during early November but recovered during the rest of the month to end slightly higher. Longer-term Treasuries fell steadily during the month with yields moving from 2.60% to 2.80%; US high-yield bonds again outperformed with yields and prices roughly unchanged for the month; high yield bonds reached their lowest spread to Treasuries in history during November 2013 [Complacency anyone? These bonds are rated below investment grade!]. WTI crude bottomed out during late November and then rallied into December, exposing a tighter supply/demand balance than was generally thought to exist during the late autumn.

December stock market performance echoed performances in October and November: early month weakness gave way to late month strength as investors drove the indices to new all-time highs (except

for the Nasdaq which is still far below its 2000 peak). Earnings gains reported during the quarter were mediocre, but the excitement for the month was that the Fed finally decided to taper its purchases of both Treasury and mortgage bonds (starting in January). The world's stock markets reacted well, since the taper amount was only $10 billion per month. [We at Kanos were surprised that the Fed decided to taper (because we continue to see the economy as moribund) and were surprised that the taper caused an initial rally – see more in the *Going Forward* section below.] The S&P 500 returned another 2.53%, led by outperformance in Materials, Industrials and Technology. Laggard sectors included Consumer Staples, Utilities and Telecommunications (the last of which lost money during the month). Prices of US Treasury bonds continued their fall, with the yield on the 10-year Treasury breaking above the 3% psychologically-important level. Amazingly, US high-yield debt rallied in December (following US equities), further compressing spreads and setting new valuation records. Emerging stock markets fell slightly during December, with late month strength overcoming pretty strong mid-month weakness. Precious metals fell during the month, but they tested and held the 2013 late-June lows on the last day of the year. Mining shares, while setting new yearly lows in mid-December, rallied into the end of the month, with some showing gains for December. WTI crude rallied strongly during the month as supplies from Libya appeared to be off the market for the foreseeable future, and cold weather impacted energy usage across North America.

Most markets seemed to reach extremes at the end of December, with stock markets around the world reaching all-time highs, and bonds setting multi-month and multi-year lows in price / highs in yield with the December taper the obvious catalyst. Commodities were mixed all quarter as best illustrated by oil, which dropped during much of the quarter but rallied strongly in December, and precious metals and agriculturals, which performed more poorly in November and December after a strong October, showing some confusion of the possible future performance of the world's economies. **We consider the bond markets to be the pivotal place to indicate direction for markets in the near future; if rates stay around these levels, bonds may be seen to provide a safer, more attractive place for capital than extended stock markets.** However, if bond markets start to move lower in a more violent manner (and rates ratchet higher), markets around the world could perform unpredictably because of the long-standing, underlying assumption of stable interest rates and ultra-cheap financing would have to be reconsidered by the majority of investors. We don't believe economies are strong enough anywhere in the world to cause interest rates to rise because of higher demand for financing forcing rates higher.

Equities

As mentioned above, US equities continued their rise throughout much of the fourth quarter, led almost exclusively by margin expansion as third quarter results showed slow growth (at best) and earnings per share gains by companies were mostly accomplished through share buybacks (thus, EPS increased due to lower share count; higher profits were not necessarily needed). Valuations of materials stocks (metals, coals, agriculturals and even energy) continued to be attractive, while valuations of most large-cap dividend paying stocks were at the high end of their historical range of valuations and a number of "high flyers" had valuations that approach tech stock valuations in the

1999-2000 bubble period. We increased our equity exposure in a small, risk-adjusted way, while constantly looking for more opportunities to find attractive risk-reward situations.

Precious Metals

After gains in October precious metals underperformed the rest of the quarter, testing the lows from June 2013 on the last day of the year (and bouncing back strongly in January). Mining shares performed better in December, with many gaining during the month as companies were judged to be running their businesses much more efficiently and metals prices were considered to be near lows. *Going Forward* below will show how compelling values are in the sector and how metals are set-up to rebound strongly in 2014.

Energy

Energy prices, especially crude oil prices, benefitted during the quarter from Libyan and Middle Eastern supply disruptions Natural gas rose due to early and sustained winter weather in North America during December. We maintained our energy exposure and while values are compelling in a number of energy sectors, we were not ready to boost our exposure to energy due to prices being susceptible to supply increases and stocks being susceptible to market corrections.

Bonds

The bond market was a study in contrasts as taper talk and the occurrence of the December taper continued to drive Treasury rates higher (and Treasury bond prices lower). Prices of higher yielding corporate bonds (especially high-yield bonds) showed price gains as investors reached for yield and judged default risks to be lower than historical norms. European bonds were also mixed, with economically stronger sovereigns (Germany, Great Britain, etc.) following US Treasury prices lower while PIIGS bonds, including Greece, Italy and Spain saw large gains in price during the fourth quarter. Why? The ECB continued their OMT bond buying (although it was "sterilized" by selling very short-term bonds or European T-bills at the same time) and investors bought those lower-rated European bonds, because they felt the ECB would institute quantitative easing (non-sterilized purchases) or would continue OMT bond buying into 2014.

Other Markets

Currency markets were the other area where there was a lot of action during the quarter. The Japanese yen continued its decline during November and December, moving above 105 to the dollar before correcting slightly as the Japanese economy improved and investors judged that the Bank of Japan would continue (or possibly increase) its monetary stimulus. Meanwhile, commodity economies like Australia (and to a lesser extent Canada) decided to try to stay competitive by "jawboning" their currencies lower, calling them overvalued and saying that they needed to fall further. In our

judgment, the currency most in need of falling (besides the yen) is the euro, but perversely, it was strong for much of the quarter. Southern Europe is in dire need of a boost to competitiveness that a lower currency would provide, but "lead sled dog" Germany is standing firm against a lower euro, and the lack of quantitative easing in Europe has led investors to stash capital in the euro to get higher rates (in lower rated European bonds) and preserve purchasing power. We are leery of this rationale, but it has caused large currency flows to push up the euro.

Going Forward

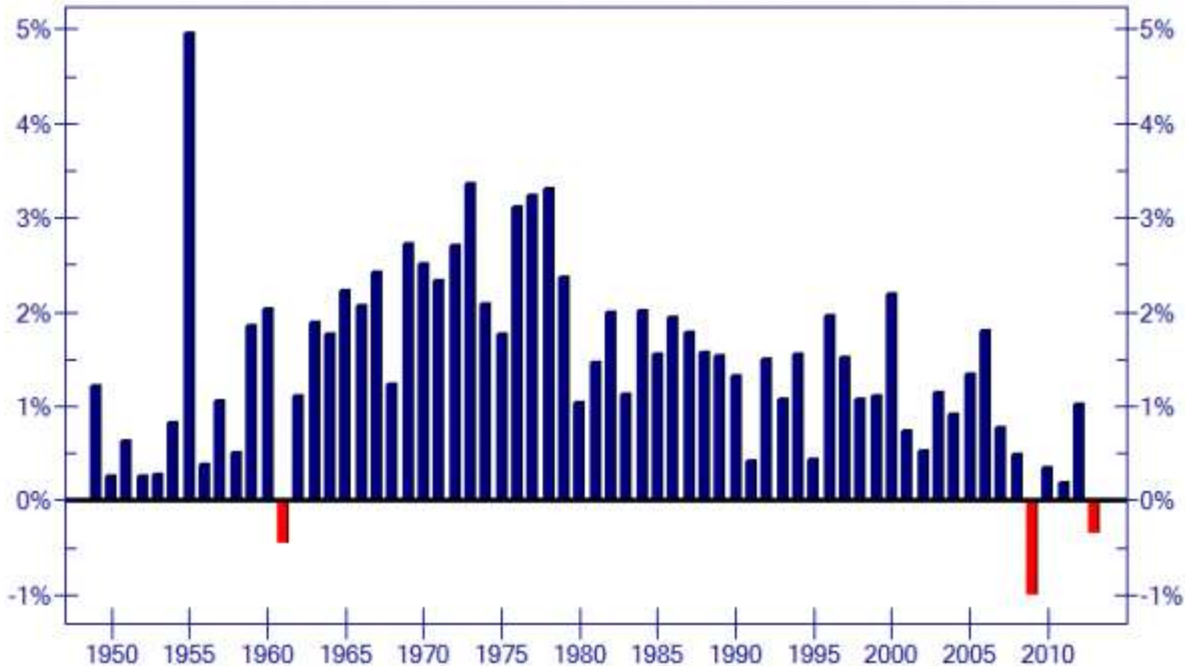
Economy

While we don't usually have a section devoted exclusively to the economy, this quarter we thought we would do so to highlight the disconnects between the US (and world) economies and the performance of stock markets around the world.

We are concerned about the pace of growth in the economy and are worried about the economy hitting "stall speed," or slowing down to the point of recession. As illustrated in the graph below from the St. Louis Fed, the growth in the labor force has been decelerating as fewer people of working age enter the workforce. This has skewed unemployment statistics to a point where they look like they are improving (down to 6.7% of the workforce), but the percentage of people in the workforce ("civilian labor force") dropped to a four decade low of only 62.8% of the working age population [see graph below]. Thus, many more people are unemployed than the official statistics indicate. A broader measure of unemployment, the U-6 measure of unemployment, includes people with marginal or part-time jobs not counted in the more widely report U-3 measure; it is what was used before the 1980s when politicians wanted statistics to look better. However, the U-6 unemployment is still measured and **is currently 13.1%**. We believe this is a much more realistic reading of true unemployment, and it is also affected by a smaller civilian labor force.

Civilian Labor Force

Annual Percent Change



Data: St. Louis Fed

In addition, strength in the economy over the past few months appears to have been enhanced by building inventories. While this kind of activity helps keep factories busy during less busy times, eventually inventories must be worked down, which leads to lower manufacturing activity in the future. So, at least some of the unexpected strength in the economy looks to be "borrowed from future activity," not necessarily evidence of primary strength of a further recovering economy. We think the slow US economy will start to affect corporate activity levels and will lead to lower profits. We also believe that the further implementation of Obamacare and its higher cost and tax burdens will retard growth, further slowing US economic momentum.

Finally, one of the cornerstones of the post-2009 recovery has been the housing market. Fed bond buying of both US Treasury and mortgage bonds drove down rates for the last few years, making financing much cheaper for homebuyers (and mortgage refinancers), driving home buying and facilitating the repair of consumer balance sheets through higher home equity. However, the Fed's "taper talk" signaling their cessation of bond buying in mid-2013 has led to higher mortgage rates, squelching mortgage applications. The graph below (from Bloomberg) illustrates that higher rates and growing lack of affordability of housing (due to years of house price recovery) have driven mortgage applications to 13-year lows. We believe this signals a deceleration of housing growth, and housing is a significant part of the economy. Thus, we are concerned about the ability of the US economy to grow with mortgage origination slowing down.

Equities

The equity markets went on a tear last year, and with quantitative easing continuing into 2014 (albeit at a slower rate due to Fed tapering), there is a chance that the US equity markets could continue to climb this year. With this in mind, we currently hold long US positions in our portfolios with an emphasis toward stocks with lower valuations and lower risks in attractive sectors and industries. However, we are worried about current stock valuations, the length of the current bull market, and the future impact of the USA's mediocre economic performance lately.

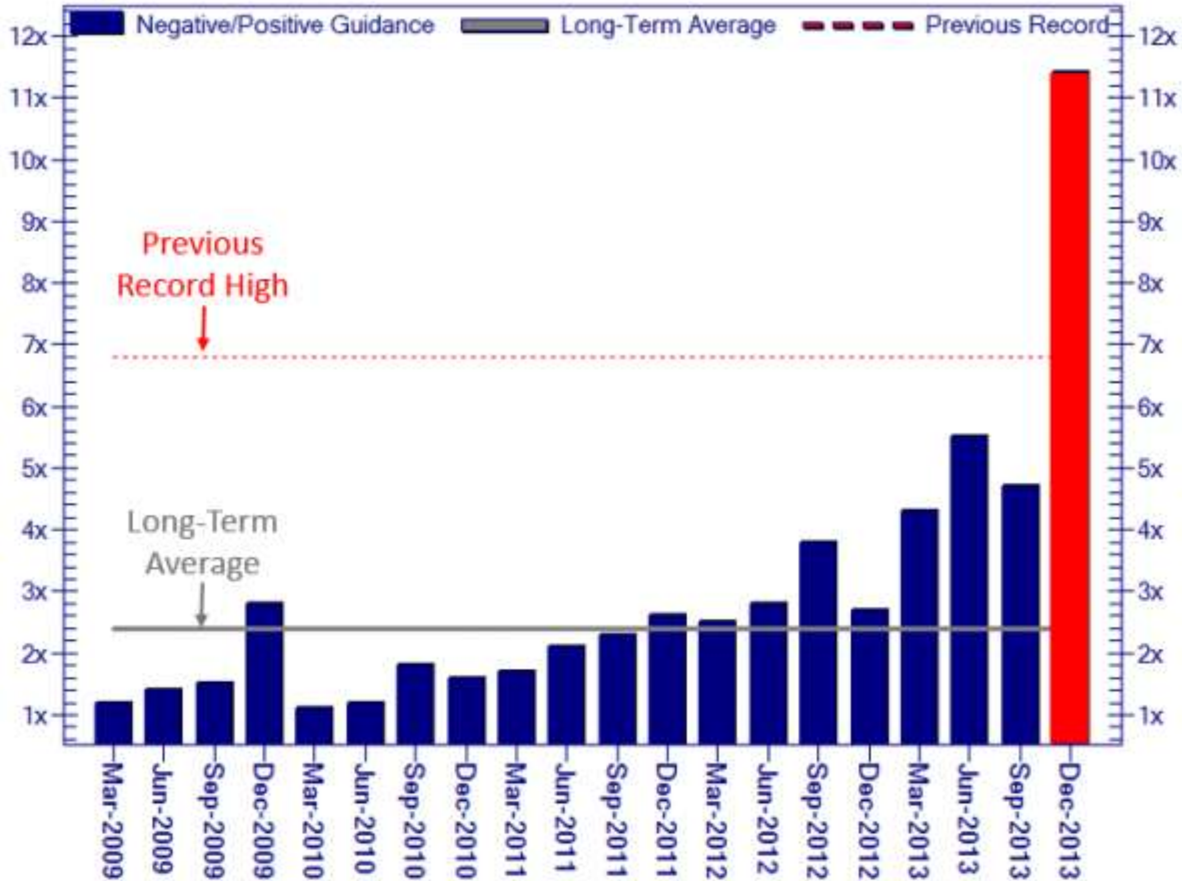
As mentioned previously, we consider stocks to generally be at high valuations, with some egregiously highly-valued companies in technology and biotech and some compellingly-low valuations in the resources and agricultural sectors. In general, equities are at the high end of their typical valuation ranges, and none other than Goldman Sachs is one of the latest to point this out; in its January 10, 2014 Kickstart Commentary, Goldman writes (via ZeroHedge "Did Goldman Just Kill The Music?):

> "The current valuation of the S&P 500 is lofty by almost any measure, both for the aggregate market as well as the median stock: (1) The P/E ratio; (2) the current P/E expansion cycle; (3) EV/Sales; (4) EV/EBITDA; (5) Free Cash Flow yield; (6) Price/Book as well as the ROE and P/B relationship; and compared with the levels of (6) inflation; (7) nominal 10-year Treasury yields; and (8) real interest rates. **Furthermore, the cyclically-adjusted P/E ratio suggests the S&P 500 is currently 30% overvalued in terms of (9) Operating EPS and (10) about 45% overvalued using As Reported earnings**." ***[Emphasis ours – KS]***

Interestingly, they received so much negative feedback from their customers that on January 21st, they had to reply (via ZeroHedge "Goldman Defends Its 'Stocks Are Overvalued' Call From Angry Clients"):

> "We received a barrage of questions following the publication of last week's Kickstart commentary about the valuation of the US equity market. Last week we argued that the S&P 500 currently trades towards the higher end of a fair value range based on a variety of metrics, and noted in particular that the P/E multiple has rarely been higher than it is now, outside of the Tech bubble.
>
> Most client responses attempted to justify personal expectations for continued multiple expansion in 2014. This supports our observation that many on the buy-side expect price gains of 10% to 20% this year, well above the 3% upside to our target of 1900 for year-end 2014. Below we continue the conversation and respond to the most common questions.
>
> 1. Many investors asked how our conclusions would change if we used a longer historical valuation series than forward P/E, which starts in 1976.
>
> The 90-year timeseries of trailing P/E multiples shows a similar picture to the 40-year forward P/E multiple timeseries. At 18x, S&P 500 still trades above average valuation, ranking in the 75th percentile historically. While this is modestly lower than the 83rd percentile ranking of 16x forward P/E, <u>the fact remains that market has rarely traded at a higher P/E outside of the Tech bubble, or coming out of recessions when EPS were extremely low.</u>
>
> 2. The low interest rate backdrop was the most common client justification for continued P/E expansion. Current S&P 500 P/E is either at or above the historical example regardless of the metric used. In addition, the Fed Model suggests S&P 500 upside roughly in line with our 1900 target given the current gap between equity and bond yields.
>
> Some clients pointed out that stronger US GDP growth and Fed taper should lead to higher yields, which have implied higher P/E historically. While this view is in line with our 2014 economic and interest rate outlooks, S&P 500 P/E already exceeds the historical average when nominal yields fall between 3-4%. While yields between 4%-6% would imply a modest 1 P/E point increase, we don't expect rates will reach that level in 2014. More importantly, averages in that bucket are largely biased by the Tech bubble."

Thus, even Goldman Sachs has analyzed the market and finds that it is overvalued by a number of measures. In addition, companies are starting to have trouble with revenue and profit growth, as evidenced by the following graph from Thomson I/B/E/S which illustrates the extremely high ratio of negative guidance from companies compared to positive guidance. This ratio has skyrocketed lately, and is currently almost 50% above the previous high. We believe profit margins revert to the mean over time, and this chart helps illustrate that mean reversion to lower profitability levels appears to be underway.



We have been underweight the market-weighting of US stocks since 2008 when we thought there would be trouble in the equity markets. We were reluctant to re-enter in 2009 in size because we thought that the financial excesses were as bad or worse than the Great Depression, when prices fell almost 90% (as opposed to the 45% losses from 2007-2009). We did not anticipate the Fed pumping **<u>$3.2 trillion of excess reserves into the financial system after lowering rates to zero and keeping them there for years while no Wall Streeters went to jail for behavior that had historically led to prosecutions and jail time</u>**. This lack of "cleansing of the system," coupled with lack of punishment, has led to a quick renewal of stock speculation that has far outpaced the slow recovery from the 2008/2009 recession. Stocks were never at bargain levels for any significant amount of time – they merely bounced off the March 2009 low and were propelled higher by easy money and artificially lowered interest rates, exhibiting barely sustainable valuations without extraordinary circumstances, which were subsequently provided by Fed stimulus. When the Fed removed those stimulus programs (the end of QE1 and QE2), stocks had large drops that then prompted new Fed programs. Now that the Fed has started to taper, we believe that we are far closer to the high for stock indices than anywhere near fair value. Thus, we are keeping our positions in tact because the markets could

continue to ride monetary stimulus momentum higher. However, we are underweight the market significantly and overweight positions we believe will benefit the most from ongoing worldwide monetary stimulus: namely precious metals, resource stocks, short yen, long Japanese stocks and long US blue chip stock indices. We could adjust these positions radically as conditions dictate.

Late note: we have been asked why markets have sold off in January, with an emphasis on emerging markets losses. We believe this is a result of the Fed tapering: when the Fed cut down the amount of stimulus going into the US economy, this led to higher rates in the US, which led to investors moving capital from higher-risk, higher-reward countries back to the US. Thus, countries with high current account deficits have been hit hardest (Turkey, Argentina, Venezuela, etc.) as their currencies have plunged as investment money moved to more attractive US fixed income. Many of these investments were financed in low interest rate countries (like Japan), so when these "carry trade" investments (financed in yen, invested in emerging markets) were unwound, the emerging markets investments went down, and the yen were bought back, leading to a slightly stronger yen. Investment managers cannot always sell illiquid investments in emerging markets, so selling has spread to most risk investments (including highly-valued US equities) as risk is reduced worldwide. Thus, the Fed has caused much of this turmoil by forcing investment managers to take more risk (by artificially depressing interest rates) for years but now pulling back on stimulus and forcing the unwind of some of these "forced" risky investments; unfortunately, we believe that this will go further if the Fed continues its tapering of quantitative easing. If world markets start to fall in a more chaotic manner, the Fed may have to reconsider its monetary policy moves going forward.

Precious Metals

The setup for precious metals prices finally seems to have bottomed out and looks set to improve after a dreadful performance in 2013. There are a number of reasons for optimism in regard to rising gold prices going forward:

1. **Large banks are long** – Generally, large banks maintain a short position in the futures markets as they hedge bullion bought from producers. They buy those futures back as their inventories are sold to end-users or investors. However, currently the large banks are long futures, meaning they believe prices are headed higher and **don't feel like they need to hedge inventories.** This is significant because it has only happened one other time in the last few decades, after which, prices went higher.

2. **Technical factors** – The technicals showed deterioration through mid-2013 when gold bottomed around $1,180/oz in late June. After strengthening in late summer, gold slumped again during the late fall and tested the June low in late December, holding at $1,182 and rebounding strongly afterward. This is one of the classic bottoming patterns in financial markets: a plunge on heavy volume, which washes out most "weak" holders; then, a re-test of the lows a few months later; followed by a recovery in price (which we are seeing currently). This is reminiscent of the bottoming of the stock market in 2002-2003 after the Tech Bubble recession. As shown below, the Dow Jones Industrials hit a low under 7,200 in October 2002, rallied strongly, then showed more weakness and

tested the low in March 2003 before rising strongly from the re-test of the bottom (the market then rallied all the way to October 2007, when it hit 14,200).

Similarly, the gold market hit its low in June, rallied strongly, then showed weakness into December, held its low, and is now rallying higher.

In addition, during the last week of December, the gold price hit the low for the move, and then rallied during the week to close above the range of the previous week. This is a formation called a "weekly outside reversal," which is also considered a strong bottoming pattern and is usually a good indicator of selling exhaustion.

Finally, precious metal mining stocks, which often move before the price of the metals, hit their recent lows on December 19th, nearly two weeks before the metals bottomed. They have rallied strongly since then. We believe this is another sign that the metals and associated mining stocks have bottomed and are set for a strong rebound going forward.

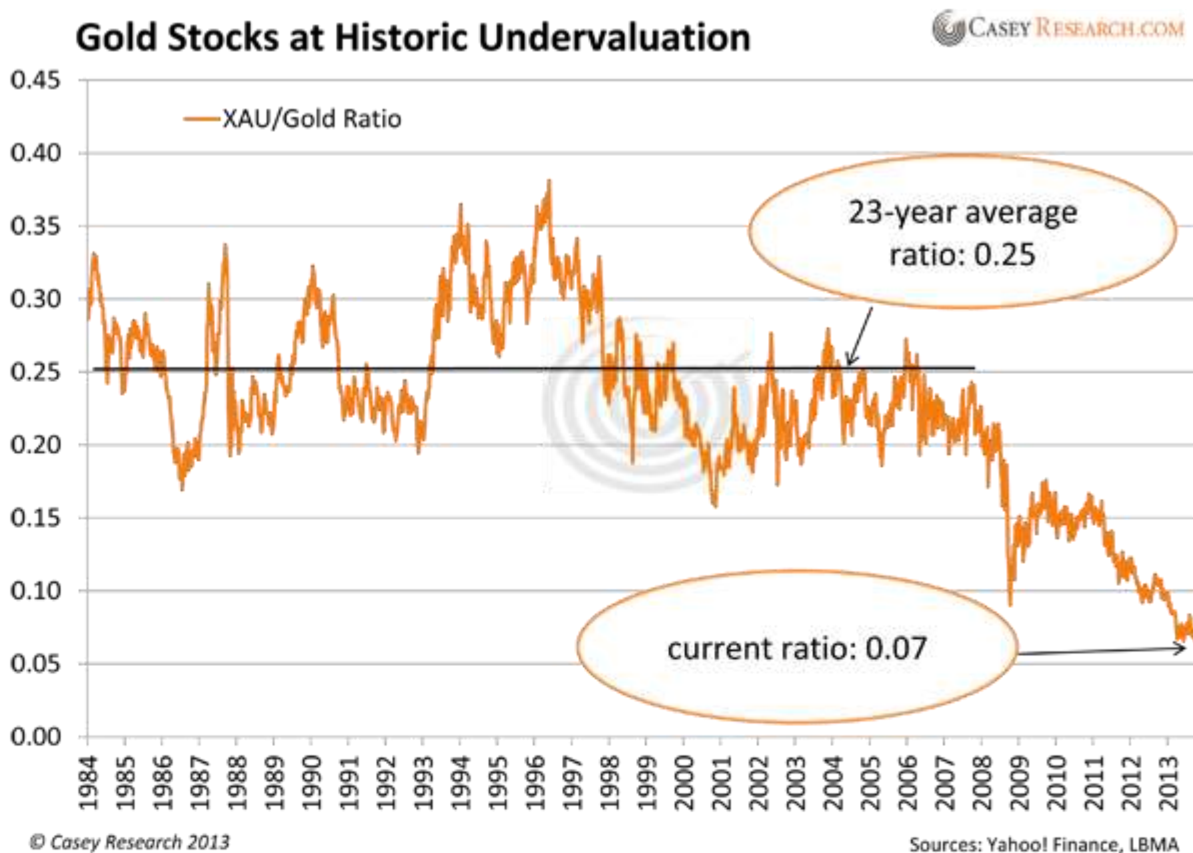
3. **GOFO has been negative for much of the last few weeks** – GOFO is the gold forward rate which measures investors' preference for holding cash over gold. When GOFO goes negative, this shows investors' preference for holding gold is higher than their preference for cash – this is an extremely unlikely situation which has only occurred a couple of times over the last decade but GOFO remained negative for weeks this fall and winter, even into 2014. This unusual situation shows high demand for physical gold which appears to be in shorter supply than market participants anticipated.

4. **Chinese imports through Hong Kong continue at historically high levels; Comex stocks are at very low levels** – Chinese demand rose to historically high levels this spring and has continued at or near peak levels through the end of the year. Meanwhile stocks of available gold at the Comex futures market in New York have dropped to very low levels not seen in many years. These situations further highlight the dwindling stocks of physical gold available for sale in New York and the movement of physical into the stronger hands of Chinese investors. Indian investors, while discouraged from accumulating gold during 2013 due to raised duties on gold imports (and some temporary bans on imports at times), continue to buy gold, in part for historical and cultural reasons but also to protect themselves from a rupee which dropped precipitously in value during the year. Thus, traditional buyers of gold, the Chinese and Indians, continue to buy gold in large quantities; and as we were going to press, there were calls in the Indian government for relaxation of these rules [because of non-compliance and widespread smuggling have filled the void, robbing the government of duties they would have gathered if fees were lower] which rallied gold higher in late January.

5. **Monetary stimulus around the world continues** – While the initial taper occurred in December, the Fed is still adding $75 billion in excess reserves monthly to the US banking system currently. Japan continues to try to drive economic growth through much more liquidity via similar quantitative easing operations and China, as we pointed out in our last letter, has added by far the most monetary stimulus into its banking system since 2008/9, and stimulus has been increasing as the shadow banking system there shows signs of overheating, leading to possible financial failures. Just as we are seeing in China, we believe that if there are economic hiccups in the US or anywhere else, monetary stimulus could increase to try to stave off deflationary forces. This would be bullish for hard assets, and we believe precious metals in particular would benefit. As a corollary, threats of (or actual) devaluation of currencies is also proving to be another bullish factor for gold – late January devaluations in Argentina and Venezuela, plus the looming threat of one in Turkey, have driven investor demand to the gold market to preserve purchasing power. Economic weakness has caused the Argentinian peso to devalued 15% against the US dollar, and Venezuelan bolivar has been capital controlled, leading to a plunge of 79/dollar from the official rate of 6.5/dollar. This type of economic dislocation has historically caused increased investments in gold for capital safety reasons.

6. **Mining companies are at historically low valuations** – Companies are valued as if precious metal will never rise again, and this year's cash flow is the sole determinant of valuation. The 2013 drop in gold prices has crimped miners' profits, but we believe proven and probable reserves (which do not include possible, measured or inferred reserves also measured by most mining companies) are wildly undervalued by the market right now. The Gold Stock Analyst publishes monthly statistics on North American mining stocks and measures valuation versus a number of factors; the blended valuation of their universe of gold mining companies was **48% undervalued from post-2008 valuations**, which have proven to be lower than valuations pre-2008.

The following graph, courtesy of Casey Research, also points out this current undervaluation, but in graphic form: the ratio of the XAU gold mining company index divided by the price of gold averaged 0.25 from 1984 to 2007. It has averaged only 0.07 since 2008, showing a strong disconnect from historical value. If this even slightly reverts to the mean (or, more likely, readjusts above the mean for a time), these stocks could triple (or more); you can see our excitement around holding positions with such potential.



Finally, in a recent conversation with a colleague, he said he thought that:

> "Gold is unanalyzable…I can put together easily a model that shows the earnings projections of a company and feel reasonably sure about its value, but with gold I don't think I can do anything analogous.

> "Financial analysts often complain that while they can model and predict the value of companies and sectors, they cannot do something analogous with gold, so it must be impossible to value. The most common complaint heard is that precious metals have no cash flow, so their value is mostly a measure of sentiment at any given time, and the sentiment that exerts the most influence on metals' prices is fear. Thus, in the absence of fear, precious metals should go down in price."

We disagree wholeheartedly. First, modeling companies, sectors or even economies involves starting with a number of assumptions, many of which are hard to forecast going forward (sales growth, input costs, even interest rates). Thus, depending on the assumptions used, the answer to the "value" of a company can be very different among analysts. Second, gold has been used as money for virtually all of human history. Even today, central banks around the world hold gold as their "base money," and generally hold reserves of other currencies for use in trade with countries who use those currencies. Thus, for valuation purposes, gold can be compared to the amount of currency and of debt in a country to see how it has been valued in the past and how its current value compares to historical valuation ranges. An analyst can also use this methodology for countries or the whole world, and while there are dislocations from these values (as we have seen over the past couple of years), capital flows and human behavior will eventually restore historical relationships.

Thus, while financial traders and some developed economy central banks have been sellers of gold in recent years, central banks around the world have been buyers and the public in places like India and China with historical, cultural and economic reasons to own gold have combined with the public from Latin America and less-developed Asia to buy physical gold to the point that traditional storage of gold in North American and European financial centers has dropped to historically low quantities. The result is a much stronger possibility of a gold market dislocation and far higher prices sometime in the near future.

Energy

Energy markets have been weak as 2014 dawns. The "charmed life" of crude oil prices during 2013 is vulnerable to rising production both in the US and Africa/Middle East. Muted economic growth has led to slower energy usage growth worldwide this past year. Cold weather in North America led to a December/January boost in natural gas prices, but in spite of the coldest weather in 20 years during early January, natgas prices have barely exceeded $5/MMBtu as supplies are judged to be adequate for demand except during extreme cold snaps. The instability in Libya and the potential for continued Iranian sanctions are keeping crude oil prices from falling below $90/bbl for WTI and $100/bbl for Brent. However, plentiful US shale oil supplies coupled with the possibility for economic slowdown in world economies make us only mildly bullish on energy prices and energy stocks at the moment.

Other Markets

Bond prices retested all-time highs in mid-2013 before falling hard after the Fed began "taper talk" in May 2013. Since then, the benchmark 10-year Treasury bond has fallen to a point where it yielded over 3.00%. This level was again achieved in early January 2014. We believe that yield will rise in the future, although only a small rise may be achieved in 2014 as economic slowdowns plague world economies. We think there will be a lot of volatility in the 2.75-3.00% range during the year, but further issuance by US Government and US corporates, coupled with building inflationary pressures, will push yields higher during the year, making longer-duration bonds go to a huge spread to artificially low short-term yields, which central banks are continuing to peg near zero for at least 2014 and 2015. As we said before, we believe this is the market that will give us clues during this year that will signal macro-economic moves for the 2014-2016 period.

Currencies seem to be the venue in which countries are "duking it out" to try to strengthen their economies ("at the expense of other countries," a phrase that is conveniently left out of government and central bank communiques so as not to anger their international compatriots). Japan has been the most blatant practitioner of this policy, and due to its long-standing economic malaise, the rest of the world has been patient as the yen has been depreciated almost 30% during 2013. Only recently has South Korea complained more loudly about Japan's manipulation of the yen lower, which the Koreans feel is most responsible for stealing market share from its export industries. The US has basically practiced devaluation too with the advent of quantitative easing in 2009, which increased the amount of dollars, lowered the value of the dollar internationally, and has led to much more competitive US industry in exports. As mentioned above, other countries have suffered from economic hardship and have devalued their currencies to try to become more competitive, Venezuela and Argentina being the latest to do so. Southern European countries like Greece, Spain and Italy would have done so if they controlled the euro, but Germany has so far been unwilling to let the ECB devalue the euro, which has made the economic hardship in southern Europe prolonged. In fact, the strong euro now has claimed France, whose leftist government recently acknowledged its economic problems and called for pro-market reforms to try to make its industry more competitive since it cannot change the euro's value. Two smaller central banks trying to use rhetoric (and the market thinks they will use monetary easing soon too) to lower their currency's levels are Australia and recently Canada, both declaring their currencies to be overvalued. All this rhetoric and action is evidence that the currency arena will continue to be the place where countries "fight for competitiveness" through altering (in almost all cases, increasing) their monetary stock to try to become more competitive. We expect more countries, especially Southeast Asian and more Latin American countries, to try to fight currency wars to become more competitive. Unfortunately, this could lead to 1997-like financial system instability that led to much lower equity prices in many countries around the world, as countries switched gears from overheated growth to economic bust. We hope world markets adjust more smoothly this time around than they did in 1997/1998.

Kanos Quarterly Commentary

The Curious Case of Bitcoin

By now, you've probably heard of, or maybe even heard too much about, Bitcoin. For those who don't know much about it, Wikipedia provides the following definition: "**Bitcoin** is an open source peer-to-peer payment network and digital currency introduced in 2009 by pseudonymous developer "Satoshi Nakamoto". Bitcoin has been called a cryptocurrency because it uses cryptography to secure funds. Transactions transfer Bitcoins, the unit of currency, between Bitcoin addresses derived from cryptographic public keys. To spend the funds associated with an address, a user must broadcast a payment message digitally signed with the associated private key. Transactions are verified by a decentralized network of computers all over the world…" What does all that mean? To us, Bitcoin is a virtual currency that crosses national borders to be used to buy and sell things worldwide. People exchange their currencies for Bitcoins that are stored as credits in a "virtual wallet" (think: debit card linked to bank account); people then use their computers, tablets or cell phones to transfer Bitcoins to vendors once they have bought something from them.

So why do people use Bitcoins? Or maybe a better question is: why do people need Bitcoins? Proponents point to their "ease of use" and "worldwide usability" as reasons for their usage. However, US dollars traditionally have been used easily worldwide, so there appears to be something more. Debit cards have been developed as a way for people to utilize their bank accounts to purchase things worldwide (wherever Visa or MasterCard are taken, which is most places these days), and debit cards are considered safe (you can cancel yours and get a new one fairly easily if you think it has been compromised). Bitcoins are (at least currently) still relatively difficult to buy (you must find a Bitcoin ATM for exchanging cash or transfer money electronically from your bank to a Bitcoin "exchange"). These strike us as difficulties that would discourage people from using Bitcoins.

So we again ask the question: why are more and more people are attracted to and using Bitcoins? Are they stable in value? As recent price volatility shows, they are definitely NOT stable in value – Bitcoins have ranged in value from around $500/Bitcoin to $1200+/Bitcoin within the last two months alone. So some people are buying Bitcoins because they believe they can make speculative profits. During this time of big stock market gains, plenty of people are attracted to trying to get rich quick through the purchase of something that shows potential for large speculative gains like Bitcoins.

<u>But to us, it seems the main reason people are using Bitcoins is because they are more and more unsure of traditional currencies.</u> Not only are they suspicious of countries' motives toward using currency movements for policy purposes, usually weakening the currency and causing "worth erosion" for savers (the Japanese are doing this with thinly-veiled economic reasoning; the US has done it under the guise of restoring economic vitality), but they are also increasingly concerned about confiscation or at least devaluation. Confiscation could take the form of "bank haircuts" like we saw occur in Cyprus, where people's and organizations' bank accounts were partially seized. Devaluation has occurred in less developed countries where all money is suddenly declared to be worth less, as just

happened (again) in Venezuela recently. Bitcoins are expected to be immune from these governmental risks, and with recently expanded governmental powers worldwide, people are justifiably nervous about preserving wealth. Bitcoins are also currently planned to be limited in quantity; the current protocol only allows for 21 million Bitcoins to ever be created. Thus, many believe that they will, over the long run, appreciate versus fiat currencies than can increase (and are currently being increased) at any possible rate, determined by bureaucrats at central banks.

Bitcoins are also attractive because they can be cryptographically concealed from governmental oversight through encrypted computer coding. With sophisticated software and careful transactions, Bitcoin transactions are thought to be anonymous, and people are attracted to this anonymity for privacy reasons. Many illegal and criminal transactions are thought to be transacted in Bitcoins for this reason. Governments use this reason to try to justify breaking into the Bitcoin realm and are trying to use this reasoning to try to regulate Bitcoins.

Of course, Bitcoins have a number of big drawbacks too:

1) The whole system is based on trust, verified by an open transaction file that tracks all Bitcoin transaction, serving as a verification for how many Bitcoins are passed and what entity ends up with specific Bitcoins. The "space" is loosely administered by a charitable Bitcoin Foundation (funded by a number of companies and only founded in September 2012) to "standardize, protect and promote the use of Bitcoin(s)…" However, this peer-to-peer model of accounting with a recently established "administrator" is not the greatest structure to address any major problems or crimes. What happens if a big problem crops up?

2) What happens if your Bitcoins are stolen? How can you prove that you had them and that someone took them illegally if transactions are done in secret? There is almost no legal precedent or a well-established body of law to govern trans-national currencies.

3) The "inventor" of Bitcoins is a shadowy figure (or group) that goes by the pseudonym Satoshi Nakamoto. Why the secrecy? Shouldn't the perceived need of secrecy lead to a lot of concern about whether everything about Bitcoins is "above board"?

4) Bitcoins are created (dubbed "mined") by computers searching for pieces of code that will fit into the existing bitcoin protocol – it is essentially the same as looking for new puzzle piece shapes to fit the edge of the current bitcoin "column". What this means is that only those with huge amounts of computing power (at this point) can create ("mine") new Bitcoins – everyone else has to buy them at the currently-prevailing exchange rate. This could lead to abuse and possible malfeasance, just as high frequency trading has skewed short-term trading in the stock and commodity markets toward those with the most powerful computers.

5) Regulatory risk: Governments use control of the currency as part of their policies, and Bitcoin is outside of their reach; thus, we could see governments striking back at Bitcoin. In fact, China has already disallowed its banks from dealing with Bitcoins. If too many countries ban or outlaw Bitcoins, where will they be usable? Central banks are used to capturing the value between the costs of producing and the value of the currency itself; we have a hard time believing that they will allow Bitcoin usage without some influence or regulation of them. Finally, taxes are a major stumbling block – how are Bitcoin transactions to be taxed? This is a major question because without a solution,

governments are going to outlaw transactions without collection and remittance of sales taxes. Also, when one sells Bitcoins, almost certainly there will be a capital gain or loss from the difference in the cost at purchase and the proceeds from sale – can those be captured to report to taxing entities? If not, we believe Bitcoin's days are numbered.

6) More people and businesses seem to be using Bitcoins, as more people ignore any danger signs and embrace the independent and (potentially) secret nature of Bitcoins. But what about the proverbial "elephant in the room": what happens if (and many say when) Bitcoins start to fail to be accepted in the future? Countries can use the rule of law to make sure their currencies are used (at least nominally) for transactions, but when confidence fails, people try to find alternatives to the "wounded" currency. However, with Bitcoin, if confidence is ever dampened enough, Bitcoins could quickly plunge in value with no ability to support the price or Bitcoin structure. If Bitcoins rise quickly in value again, but then the "bubble pops," this could lead to a catastrophic loss of confidence and the end of Bitcoin usage. Many financial pundits believe Bitcoin will eventually be replaced by something else, whether people are "scared back into" traditional currencies (US dollar, yen, euro, pound, and other dollars) or whether a better, more attractive alternative currency is created. The problem is that any of these scenarios leads to a situation where wealth stored in Bitcoins will drop to being worthless.

In summary, we continue to be intrigued by Bitcoins and we'll continue to monitor their price, usage and acceptance. They seem to us to be another "barometer" of people's fears of fiat currency (currency created at the whim of governments and associated central banks) coupled with people's greed for speculative gains that Bitcoins seem to offer and their lack of fear of catastrophic loss in the case of disaster or government actions. We do not think Bitcoin will survive, but it seems like the success so far of Bitcoin shows that there are large numbers of people **very concerned about their ability to preserve wealth using current options.** That, to us, speaks volumes about growing uncertainty around the world. **The fact that people would go to the extremes of storing wealth in electronic constructs like Bitcoin (with no tangible value whatsoever) shows the paranoia and concern that exists in people's minds.** It also probably helps highlight the size of underground/ crime-based effects on world economies.

Finally, the continued existence, usage and media coverage of Bitcoins make us feel like our championing of precious metals and companies that own large reserves of them makes very good sense. Gold, silver and other precious metals seem to us to be far better alternatives for preserving wealth than arcane cryptocurrencies that may or may not be worth something five minutes from now. **Precious metals have been used for thousands of years and are still used today by the world's central banks as monetary reserves vital to running national economies, underpinning currencies and supporting international trade and finance. Metals are a far better alternative to paper currency as a store of wealth. As more people rediscover this fact, gold, silver and the other metals will recover recently lost value and reconnect to the vast amount of recently created money worldwide – of this fact we are certain; we are only uncertain about the timing of this revaluation.**

The Managers of Kanos Capital Management
© 2014 by Kanos Capital Management, LLC All rights reserved.