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CAPITAL MANAGEMENT, LLC

Second Quarter 2014 Investor Letter

Portfolio Comments

The second quarter was an exciting time to be in the financial markets; geopolitical events and monetary policy announcements dictated much of the movements in a number of markets. Interestingly, the volatility of many markets was historically quite low, meaning markets did not "expect" geopolitical events to change economic conditions in the near term. Our portfolios were set up to receive much of the benefits of continued easy monetary policy and revaluation of lower valued assets. We believe our portfolios will continue to benefit from easy money, global political turbulence and continued (albeit sluggish) economic growth around the world.

Second Quarter Market Conditions

April was an up-and-down month with geopolitical happenings impacting some financial markets more than others. The S&P 500 moved up fractionally (+0.74%), led by the Energy, Utilities and Consumer Staples sectors. Financials and Healthcare were the worst performing sectors. Continued unrest in the Ukraine impacted Eastern European financial markets, with the Russian and Greek markets dropping the most, while the Japanese stock market was the notable loser of the developed markets. The British and Spanish stock markets were the best performers. Bonds were higher across the board, with Treasuries, US corporates, high yield and international bonds all rising modestly in price (dropping in yield) during the month. The Commodity Research Bureau index of commodities rose during the quarter, led by corn and wheat prices which both rose more than 2% during the month. Gold and Brent crude oil gained in price while silver and WTI crude dropped.

In May, the market mostly reversed higher, with stocks rising, for the most part, and commodities falling. The S&P 500 was up 2.35% for the month with S&P sectors Technology, Telecommunications, Materials and Healthcare rising the most, while Utilities and Financials lagged. The Russian stock market came roaring back (up over 8% in May), as did most developed market stock markets, led by Hong Kong's Hang Seng index, Germany's DAX index and Japan's Nikkei, which were all up over 2.3% in May. Bonds performed well again in May throughout the world, led by European and US corporate price gains. The grains gave back their gains from April, losing more than 10% on the month, and dragging down the CRB commodity index, although crude oil prices did rise 3% during the month. Gold and silver were losers for the month, as were mining shares, giving back some gains from earlier in the year.

June was an eventful month. First, on June 5th, European Central Bank (ECB) President Mario Draghi revealed surprising results of the latest monetary policy meeting: 1) a negative 0.10% interest rate for

1217 South Shepherd
Suite 200
Houston, Texas 77019
www.kanoscapital.com

money kept on account at the ECB by banks and large companies, 2) stopping the sterilization of European bond buying in the ongoing European SMP program (which effectively makes the SMP purchases quantitative easing), 3) the offer of more virtually zero-cost Long Term Refinancing Operations [LTRO] term loans and 4) the further lowering of many other benchmark interest rates. Lastly, he closed with the statement: "Are we finished? The answer is no" [which many market participants interpreted as a hint that the ECB could institute some sort of outright quantitative easing in the future, further easing monetary policy]. Elsewhere, on June 10th, a Sunni Muslim extremist group called the Islamic State of Iraq and Syria (ISIS) assaulted and captured Mosul, Iraq's second-largest city, and followed it up by capturing most of northern Iraq (except for the Kurd-controlled oil fields around Kirkuk), destabilizing the region and causing oil prices and global "geopolitical temperatures" to rise. On June 18th, Janet Yellen and the Fed's Federal Open Market Committee (FOMC) met and announced the continuation of current policy (and more tapering) and the anticipation of no other policy changes in the next few months. US CPI [inflation] statistics had just been announced prior to the meeting, and they had come in HIGHER than the Fed's target, but Chairman Yellen commented in the news conference following the meeting that **this was "noise" and policy would not be adjusted until forward inflationary expectations showed much higher expectations for the future**. In addition, Chair Yellen said "I think it's important to remember that, broadly speaking, inflation is evolving in line with the [FOMC's] expectations." This triple "whammy" of easy monetary policy, geopolitical upheaval (don't forget the simmering Ukraine-Russian border conflict also) and emerging inflation impacted markets during the month. World stock markets, for the most part, took the news in stride as worldwide money creation continued to push up stocks. The S&P 500 was up 2.07% in June, led by the Energy and Utility sectors. The Telecom, Consumer Staples and Industrials sectors lagged. European stock markets retreated in June, while beaten up markets like Russia and Brazil advanced the most during the month. Bonds around the world ended June on either side of unchanged, showing some flight to safety buying offset by some worry about building inflation influences. Gold, silver and mining shares were up strongly during the month, with silver and gold rising 11% and 6% respectively, as inflationary concerns combined with global unease continued to push people into precious metals. On the flip side, excellent growing conditions made corn and wheat prices plunge during June, pushing them to being the worst performers in the second quarter.

Equities

For the quarter, the S&P 500 was up 5.23%, and beaten up stock markets were the best worldwide performers – Russia, Spain and Hong Kong. While geopolitical events headlined newspapers during the quarter, most stock markets around the world rose. US equity markets took their cues from continued easy monetary policies and the perception of containment of military conflicts. Second quarter economic conditions were expected to bounce back domestically after a poor first quarter, and the Fed's apparent inclination to stay "behind the curve" (and keep monetary policy easy for possibly longer than is warranted by economic activity) helped push up the stock market. The S&P Energy (up over 12%), Utilities and Technology sectors were the best performers during the quarter. The

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Telecom and Financial sectors were the laggards. Only economic "basket cases" Greece and Portugal showed substantial equity market losses during the quarter. European banks also performed poorly during the quarter, affected by governmental fines and concerns over equity levels compared to asset portfolio sizes. See the Equities section of "Going Forward" below for more commentary.

Precious Metals

Precious metals performed well during the quarter, weathering a swoon during May. Silver and the junior gold miners gained the most, reiterating the idea that when the riskiest assets in the complex (volatile silver and small cap explorations companies) outperform the more stable components (gold and well-capitalized precious metals producers), a bullish phase is in progress. Further confirming this bullish trend, gold has made "higher lows" since completing its "double bottom" pattern in December 2013, which in technical analysis jargon means that gold is building a bullish price pattern after setting a bottom in mid-2013 that was confirmed as the bottom in late 2013. Despite precious metals mining shares outperforming the physical metals during the quarter, The Gold Stock Analyst still estimates that at current gold prices and using valuation ranges since 2008, **gold stocks still trade at a 37% discount to fair value, or put another way, they trade as if gold is priced at $839/oz, instead of the $1,327/oz closing price on June 30th.**

Energy

As noted above, crude oil prices rose strongly during the quarter due to geopolitical turmoil in the Middle East (Iraq) and the Ukraine, further buoyed by continued supply interruptions in Libya. With demand still high (and inventories needing to be replaced after the worldwide cold winter), WTI finished the quarter at $106.07/bbl. Energy stocks were the best performing equity sector during the quarter, with a 12.09% total return, led by a 5.05% gain during June. US natural gas, however, did not perform as well as crude oil, as supply concerns after the cold winter were met with large increases in production, satisfying current demand and allaying fears of a shortage of gas to fill storage in time for next winter. Natgas prices settled nearly unchanged for the quarter at $4.44/MMBtu, after rising as high as $4.88 in late April and mid-June.

Bonds

Bond markets were better-behaved during the quarter, as their status as a safe haven offset any inflationary fears. US Treasuries stayed mostly within a range during the quarter, with 10-year Treasuries varying between yields of 2.80% and 2.40%, mostly dropping during the quarter and finishing with a yield of 2.51%. Emerging markets bonds were the best fixed-income performers during the quarter, while English Gilts and US and European financial sector bonds rose the least. US High yield bonds rose over 2% for the quarter, finishing the quarter flirting with all-time low yields around 5% set in May 2013 (when Treasuries were 1% lower in yield!).

Other Markets

Soft commodities, highlighted by the grains (corn, soybeans and wheat) were strong earlier in the spring as cold weather impacted supplies. However, nearly perfect growing conditions around the world look to have developed a record crop for the grains, and grain prices have plunged since May, making grains the worst performers (by far) in the financial markets.

Going Forward

Economy

The economy has continued to show an uneven, slow recovery from the 2008/2009 bottom of economic activity. The real economic news was the May announcement that first quarter 2014 GDP had a reading of -2.9%! While bad weather did limit economic activity at times during the quarter, this indicates a real slowdown occurred. Economists were initially expecting a strong "snap-back" from the economy after the first quarter slowdown, but through statistics reported through mid-July, it looks like growth has resumed in a most tepid manner, with GDP for the second quarter expected to print in the 2-3% range.

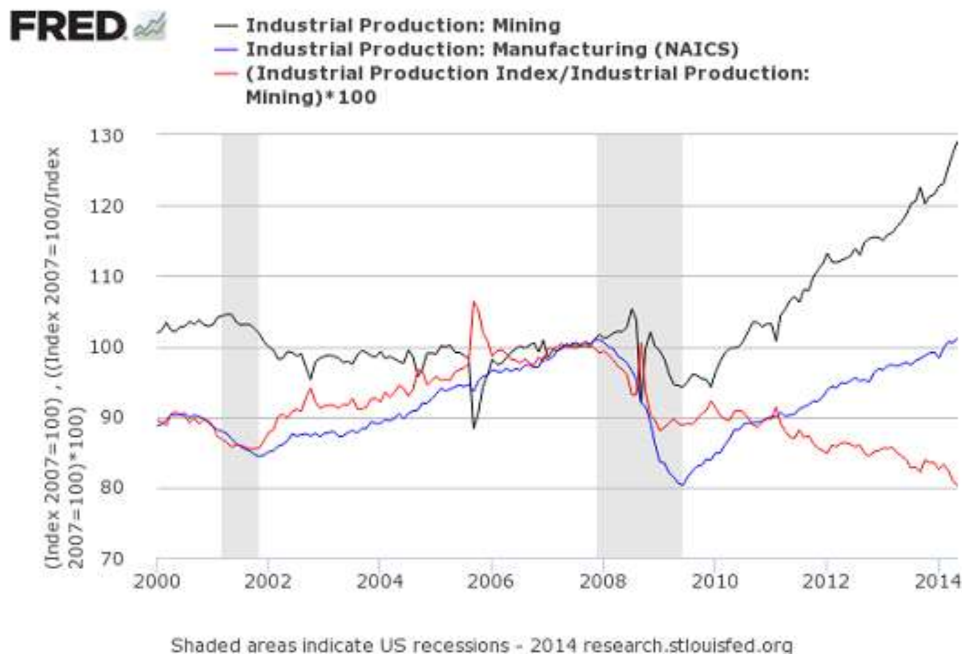
The primary concerns are the lack of a pickup in capital investment by corporations and the stagnation of the housing market in 2014 after recovering from 2009-2013. The economy seems to be adding jobs at a reasonable clip, at approximately 200,000/month, although many of these are part-time jobs and the labor force participation rate continues to hover near 40-year lows. Consumer sentiment has continued to be high, which is interesting in the face of stagnant real wages over the last few years and muted consumer spending in 2014, which usually correlates to lower consumer confidence readings. Housing prices have continued to rise, but housing starts have plateaued at only half the level of the 2006 housing peak (and many of the recent starts are multi-family, which aren't as helpful to the economy as single-family starts, which are a good indicator of new family creation).

What recent economic statistics have revealed is a slow build in measured inflation, which is pretty obvious for anyone who eats, drives a car, pays tuition, insurance, etc. David Rosenberg, the former chief economist with Merrill Lynch and current chief with Gluskin Sheff (one of the largest wealth managers in Canada) had a very good description of the current inflation situation in his June 24, 2014 *Breakfast with Dave*, in which he talks about building inflation pressures:

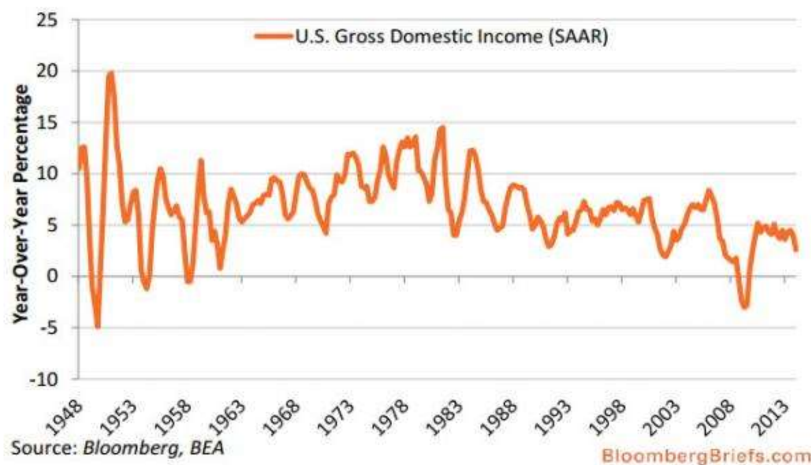
> "At 228 basis points, 10-year TIPS break-evens are at the widest in six months ***[translation – inflation as measured by inflation-adjusted Treasury bonds (TIPS) is now expected to be 2.28% for the next ten years, the highest expectation in six months - KS]*** – so no wonder, with inflation expectations embedded in the bond market stirring, that we are seeing gold on the verge of a breaking out here.

> **"Remember the classic inflation domino game that follows on the heels of every Fed easing cycle; the only variable that changes is the lag. It starts off with assets (+10% YoY on the household balance sheet [currently – KS], then on to credit (+5% YoY growth in bank lending [currently]), then to consumer prices (+2.1% now on a YoY basis) and then to wages when the cycle becomes perpetual barring a monetary policy response.**
>
> **"Wages follow prices, they do not lead them. But when they start playing catch-up, we either get a self-sustaining inflation cycle (which perhaps the Fed wants to see as a measure to bail out debtors like Uncle Sam and the legions of mortgage borrowers who are still upside-down) or margins start to get seriously squeezed…or a combination of both (which is why exposure to hard assets like property and commodities is generally a winning strategy in this particular state of the cycle** – remember, we do have less than six month's supply of homes on the market which means real estate inflation, while slowing, will be here to stay)." **[Emphasis ours – KS]**

In addition, there are a few economic data points that concern us, and we believe they help show some of the continued weakness and poor condition of the US economy. First, Charles Hugh-Smith of the OfTwoMinds blog presented on ZeroHedge.com on June 27, 2014, stated: while US industrial production has been rising since the end of the recession in 2009 (see the blue line on the graph below from the Federal Reserve Bank of St. Louis Research), the increase has been entirely attributable to the US oil & gas sector and the development of unconventional reserves made possible by improved fracking and horizontal drilling techniques (see dark green line on the graph). Absent this increased energy exploration/development activity, **US industrial production (ex-mining/energy) has been dropping pretty steadily since mid-2011.** We think that is a big concern.



In addition, fellow skeptic Rich Yamarone of Bloomberg pointed out on June 26, 2014 on *Bloomberg Briefs* that one of the US Bureau of Economic Statistics lesser-known statistics, the US Gross Domestic Income, has never grown at the current pace (2.6% year-over-year) without the US "ultimately falling into recession". You can see in the chart below that the rate of growth in income has been falling since it "peaked" (at the lowest "peak" since the statistical series started in the 1940s) in mid-2011. Growth has been sliding and is currently back at the year 2000 levels, which are the lowest levels seen since the early 1960s (besides the 2008-2010 financial crisis). In our opinion, with US income levels growing so little, it is just a matter of time until consumers curtail their purchases further and send the US into a true recession, not the kind of quasi-recessionary conditions that we are currently experiencing, with low economic growth that is concentrated in only certain industries and certain parts of the country.



Finally, the Eurozone continues to barely grow in spite of the increasing amounts of monetary stimulus and governmental support put towards stabilizing European economies. The ECB moving to negative interest rates, undertaking de facto quantitative easing and promising "more" shows the sad state of Europe's economies. Throw in that the Russian/Ukrainian civil war affects European trade and, potentially, an increase in cost of, or even interruption of, energy supplied to Europe from Russia through the Ukraine, and we believe there is extreme risk of European economic upset and possibly a 2014 recession due to reduced economic activity and raised costs.

Two more items we saw which gives us pause are: first, the introduction of a tax on bank deposits in Spain: according to Reuters on July 4, 2014, Spain is going to introduce a "blanket taxation rate of 0.03% on all bank account deposits". While this is seen as a way to generate extra tax revenues, it is almost certainly going to lead to capital flight, which is the last thing Spain needs right now. Capital flight would worsen an already fragile Spanish economy, which has been touted as one of the better economic recoveries in the Eurozone. The second, of course, is the financial trouble of the Banco Espirito Santo in Portugal and its parent company; when European banks start to have real financial trouble, there is a risk of a domino effect since many large European banks have derivative books that interlink them more than regulators would like to admit. Espirito Santo may not be the spark that sets

off expanding financial distress, but where there is smoke, there is usually fire. We hope that European banks can keep any collateral damage to a minimum.

Equities

The US stock market has recovered from its spring swoon, with all indices at or near yearly (and in some cases all-time highs). The power of a rising money supply continues to power higher equity markets in the US, with most sectors participating. We have maintained our equity exposure but believe we hold a portfolio of stocks with relatively lower valuations and resource positions that will benefit from the higher inflation building in the financial system. We are more and more concerned about highly-valued stocks that may miss on their ability to keep growing either their revenues or their profits. Earlier in 2014, we saw the first cracks in many of the high-flyers and small cap stocks that have outperformed over the past couple of years. However, the rest of the US market has moved up enough to send indices to new highs during the summer.

The market appears to be nearly "bullet proof" as almost all forecasters see the market higher for the year, and in some cases, longer-term. Unfortunately, this reminds us of another time when we were investing and the outlook for the market seemed to be higher forever: 1999-2000. At that time, technological advances, the emergence of China and the entrance of much of Eastern Europe to the world economic system led to new demand, new technologies, higher levels of trade, higher productivity and rising standards of living. Equity investors became even more euphoric as the Fed, led by Alan Greenspan, pumped the economy full of liquidity to head off any Y2K computer problems that might temporarily hurt the economy at the turn of the century. Valuations skyrocketed, new concept and very unprofitable companies had spectacular initial public offerings and many investors projected high growth far into the 2000s. The stock market was bifurcated, with exciting, growth-oriented technology stocks moving to historically high valuations, and many industrial and "old economy" stocks either rising very little or in some cases dropping in price. Investors made money, but huge gains were mostly made by taking valuation risk in technology or technology-influenced companies.

As we know, valuations and expectations got far ahead of themselves and the actual economy. Stock markets cracked as valuations became too high and the economy started to slow. Some high valuation stocks lost more than 90% of their market value (including mighty Amazon, which lost 95% of its value), while other companies completely disappeared. Broad stock market indices lost almost 40% in price as valuations were revised lower by investors and traders.

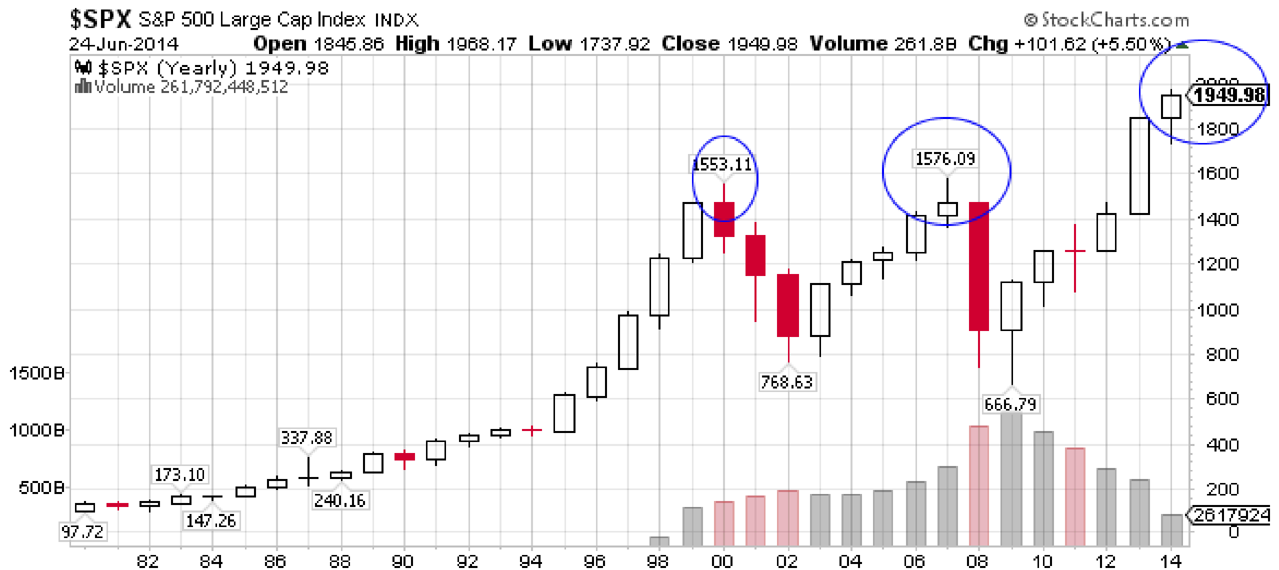
Historical stock market valuations are now up to levels only seen in 1929, 2000 and 2007 previously. Professor Robert Shiller of Yale University, best known for his 1990s book Irrational Exuberance and his real estate valuation index (the Case-Shiller Index) is also the creator of a cyclically adjusted ten-year price-earnings ratio, known as the CAPE (Cyclically Adjusted P/E). In an interview with The Daily Ticker on June 25, 2014, Professor Shiller, when asked about stock market valuations, responded: "I am definitely concerned. When was [the CAPE] higher than it is now? I can tell you: 1929, 2000 and 2007. Very low interest rates help explain the high CAPE. That doesn't mean that the

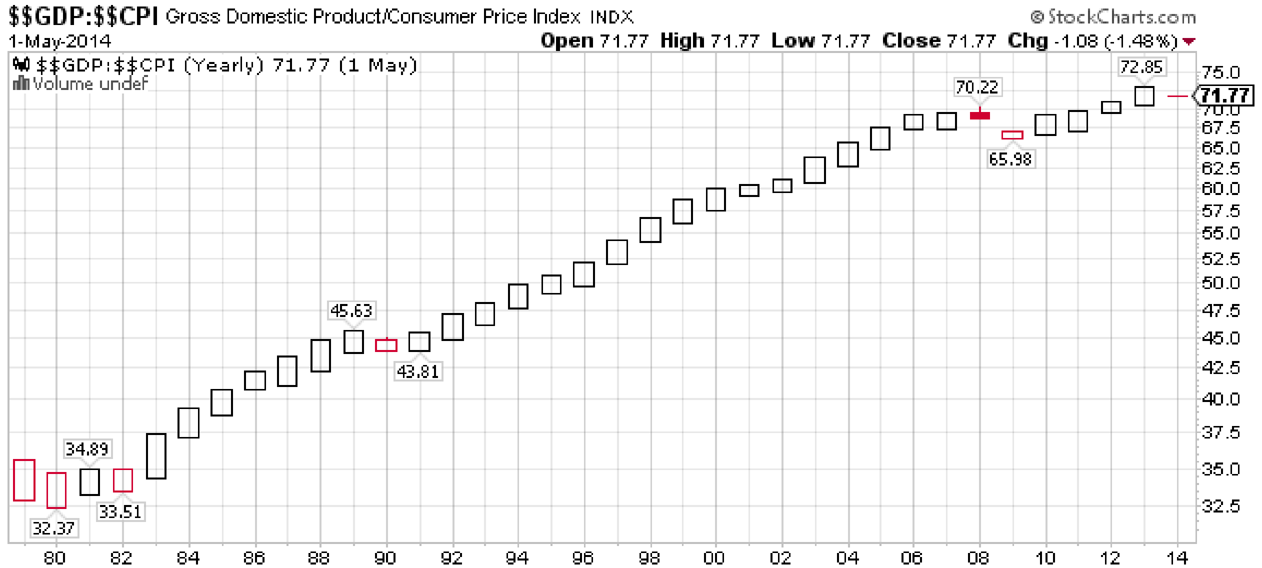
high CAPE isn't a forecast of bad performance…One thing though, I don't know how many people look at plots [charts] of the market. If you just look at a plot of one of the major averages in the U.S., you'll see what look like three peaks – 2000, 2007, and now – it just looks like a peak to me…It's likely to turn down again, just like it did the last two times."

Below is a graph of the S&P 500 since the 1980s (as formulated by Grant Williams, Hong Kong fund manager) which shows the yearly market performances. The circles represent the last two market tops and the current market level (as of late June 2014). The market has gone from a low of 97.72 in 1980 to approximately 1950, a rise of almost 2000% in approximately 30 years.

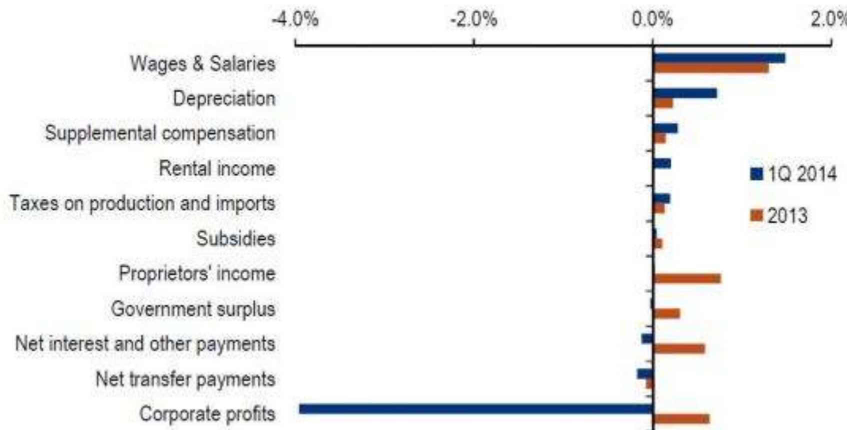
The second graph, US Gross Domestic Product divided by the US Consumer Price Index, gives us the real rise of GDP for the same period. Since the bottom in 1980 at 32.37, real GDP has risen only 122% in 35 years. Since the financial crisis hit the markets, real GDP is only up 2.2% since 2008, while the market is nearly 24% higher than its peak in late 2007 and up almost 200% since the trough in March 2009.

Like Professor Shiller and fund manager Williams, we are very concerned about the level of valuations in the market, although there does not seem to be any slowdown in momentum in the short- or medium-term. We remain almost fully invested, although we own many things that we believe will do better in a rising inflation, growth-challenged economy that we see coming sometime in the future.





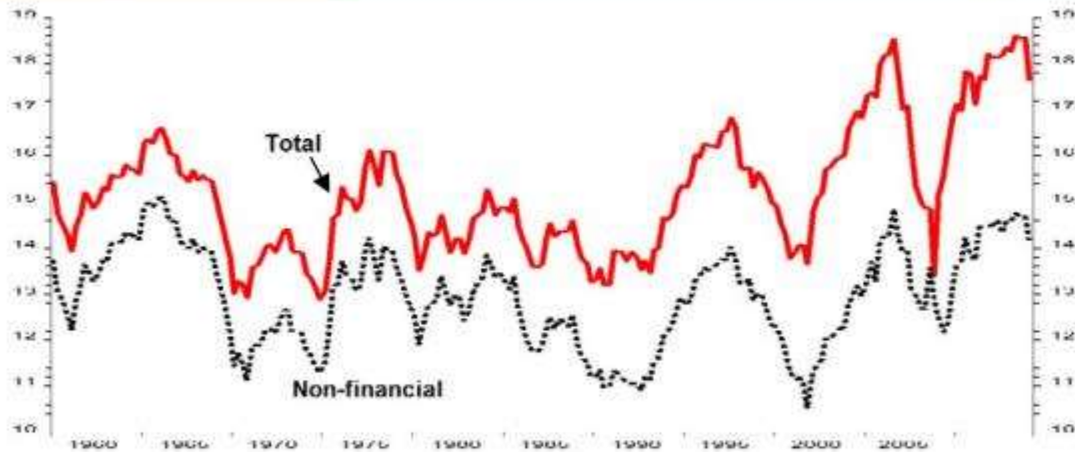
Other worrisome signs have also emerged: first, according to a May 2014 AAII survey, the assets in "bear market" funds have hit all-time lows, showing an almost universal bias towards an ever-rising stock market. Traditionally, low bearishness and few bearish bets signal a "toppy" stock market. Second, according to a number of brokerage firms, first quarter profits tumbled from recent record highs. Bank of America, in a mid-July 2014 note, showed that the biggest driver of the decline in first quarter Gross Domestic Income was the decline in corporate profits (see chart below).



In addition, Albert Edwards, chief economist at SocGen, notes in an early June 2014 note that US corporate profitability, one of the chief legs holding up the US stock market valuations, may be rolling over. He shows that pre-tax domestic profits as a percentage of GDP looks to have dropped in the

fourth quarter of 2013 and then further in the first quarter of 2014. Falling profit margins could severely affect the US stock market as future profits might be thought to be at risk.

Pre-tax domestic whole economy profits (with IVA and gross of depreciation) as a % of GDP



Source: Datastream

Special Note: INDIA – With the election of Narendra Modi as Prime Minister of India and his Bharatiya Janata Party winning an absolute majority in the lower house of India's parliament (as well as having Raghuram Rajan, a conservative economist as Governor of the Reserve Bank of India since last year), we believe India has achieved a political and monetary situation that should lead to reforms and a leaner, more efficient economy which could propel India toward a more "first-world" economy. Modi and the BJP are the first non-socialist-leaning government in India in decades; Reserve Governor Rajan has reformed monetary policy since last year, when India was exiting its most recent recession. Now all the pieces are in place for an economic and industrial renaissance, and we have invested in Indian stock market ETFs to take advantage of this situation. We believe that, although reforms are always difficult, the real mandate given the BJP and Modi's track record for reform and economic growth that he showed as Chief Minister of the Gajarat state in India should translate into more healthy and sustainable growth of the Indian economy for years to come (the majority election results allow the government to be guaranteed at least five years of rule).

Precious Metals

While precious metals prices have still not bettered their mid-March highs, the price behavior since late May has been extremely constructive. What had looked like a technical breakdown in the gold price in late May petered out and reversed to the upside in early June when the ECB introduced its inflation-friendly programs detailed above.

In addition, both silver and mining stocks have performed even better than gold since early June, showing more interest in more leveraged ways of investing in the precious metals. In fact, the Market

Vector Junior Gold Miners ETF (GDXJ), which represents the small, very speculative gold mining stocks, has performed the best since June 1st, rising more than 20%, while the larger miners (as represented by the Market Vectors Gold Miners ETF [GDX]) have risen 17%, to gold's 5% gain in June and silver's 10% rise.

Finally, gold mining stocks have been rising on some days when the gold price has weakened. Large sell-offs, like we saw all too frequently in past years, have been infrequent and much shallower when they occur. We believe we have seen not only the price reverse to the upside in a new bull phase, but more importantly, the psychology of the market seems to have changed to one more supportive in price. We anticipate that rising inflationary pressures and changing attitudes toward higher inflation expectations will only bolster the bullishness for precious metals in 2014 and the future.

Energy

While energy prices have appeared vulnerable to us due to slow growth in demand and seemingly higher production ready to appear at any moment, energy stocks have shown more optimism, although valuations of many energy stocks are still lower than their counterparts in other US stock sectors.

Crude oil prices have held around or above the $100/bbl price in spite of apparent looming production increases from Libya, Iraq, Iran and the United States. US production has been boosted to the point where we are producing at virtually the same level as the other two large producers in the world, Russia and Saudi Arabia, averaging nearly 10 million barrels per day of production. Libya has had nearly all of its production off-line as tribes fight over control of the export terminals. Iraq has seen sectarian violence limit the amount of exports it has been able to execute (and this was before ISIS further muddled the political picture). Iran, with more than 1 million barrels of capacity off-line due to sanctions by the West, has been silent lately and could lobby to have some of its capacity return to exports. So, there are many threats to prices due to potentially increasing production, but prices have stayed high. Perhaps this resilience is due to the very cold winter of 2013-14 and the restocking of drawn-down supplies as well as production restraint by the rest of OPEC. Even so, we are still concerned that prices will drop from current levels.

Natural gas prices have dropped this summer as production has grown to the point that people are far less concerned about the ability to meet current demand needs as well as fill storage to a point that will be sufficient for next winter's demands. Contacts in the natural gas industry continue to talk about the large amount of additional production that could come on-stream in the very near future, merely dependent on higher prices.

In spite of the facts presented above, many US shale producers are valued at very high multiples, as Wall Street believes they can translate their increased drilling activity into increasing profits in the future. We believe that many of these producers will be hard-pressed to produce profits in line with Wall Street estimates. Therefore, we have limited most of our investments to more conventional, lower valuation energy firms with lower growth but more stable profits (due to more predictable

costs). As the evolution of shale continues, we will evaluate profitability to see whether we might expand our investments in more shale-oriented companies.

Other Markets

The bond market continues to confound commentators as government bond yields in both the US and Europe stay at extremely low levels. Bond bears point at apparent rising global economic growth and building inflation pressures as reasons why bond rates must rise. Throw in the fact that the Fed is tapering its bond purchases, slowly removing the largest buyer in the market, and there is more reason to think rates should rise in the future. Many in the financial markets believe that current low rates don't compensate bond holders enough for the risks bonds contain, and that these risks eventually must push rates higher.

On the other hand, the lack of supply of Treasuries and other high-quality collateral (due to government bond buying by the Fed, Bank of Japan, ECB and European stimulus programs) and a growing need, especially by pension plans and other long-term investors, to hold long-dated income, has led to a constant bid for bonds, leaving rates low. In addition, a large number of participants in the financial markets believe global economic growth is anemic at best and low rates are needed to counterbalance the risks to growth and equity valuations. Government bonds are still considered the ultimate safe haven, and when geopolitical events or economic upsets occur, many in the financial markets buy Treasuries, UK gilts or German bunds as a place to keep money safe – this buying has been more obvious lately as Middle East and Eastern European hotspots have flared up in 2014.

We understand both arguments presented above, and believe more in the former – that bond rates are headed up in the future. However, we also see plenty of reasons for investors to move money to safety, so we see the bid for bonds to continue until more severe cracks evolve in either the US economy or financial markets that directly affect credit concerns. Thus, we don't see a move to much higher rates in 2014 and believe that it will take an actual attempt at tightening interest rates to get bond buyers attention and possibly lead to higher rates next year.

US high yield debt (formerly known as junk bonds) has performed very well over the past year, keeping pace with the US stock market and outpacing Treasury gains, meaning high yield spreads were contracting to nearly historic lows. Since late June (and through much of July), high yield bonds have far underperformed the S&P 500 index, leading some to worry that high yield bonds are signaling a weakening of stock indices in the future. It happened in 2007/8, albeit with a many month lag, as lower-rated bonds (subprime mortgages et al.) saw trouble starting in 2007, but US stocks did not react much until early-to-mid-2008. The following chart from Bloomberg (via ZeroHedge on 7/30/2014) shows this divergence:

Final Comment

Stanley Druckenmiller, the former chief portfolio manager for George Soros and then a very successful hedge fund manager in his own right at Duquesne Capital, gave an extraordinary speech and interview at the Delivering Alpha conference in New York on July 16, 2014. While we have not always agreed with Mr. Druckenmiller, we believe he has spoken a lot of truth that many others in the financial markets have been reluctant to say. His speech can be found at http://www.cnbc.com/id/101838762 , but here is part of the transcript from his question and answer session with CNBC anchor Joe Kernan after the speech.

> STAN DRUCKENMILLER: "…So IPOs, as you probably know, we're right on the border of where we were in '99. **In '99, 83 percent of IPOs went public had never earned a dime. Today that's 80 percent. It's the only other time in history we've approached that.** ***[Emphasis ours – KS]***
>
> So for those who say how great it is that IPOs are encouraging investment, how good that is for employment, again it's myopic. It's good for employment today, but it's not good for employment — it's like all the high-tech firms in '99. You got a job there and then you're laid off or fired or your company goes bust. So that's the IPOs.
>
> When I look at credit, it's a little more problematic. You probably saw in the Economist this weekend, S&P, this year, **corporate credit is growing as at a record rate, far faster than it grew in 2007. And S&P pointed out that 70 percent of debt issued is a B rating or worse. To put that in perspective, in the '90s, that number was 31 percent.** ***[Emphasis ours – KS]***

Do you remember all the hullabaloo in '07 about covenant light loans? They did a 100 billion in '07, and 38 percent of them were B rated. This year we're going to 300 billion. We did 260 billion last year, up from 90 billion a year, and 58 percent of them are B rated. ***[Emphasis ours – KS]***

So anybody who says they are not a bubble, I just don't agree with it. But you've asked a better question, so what? Because the bubble is appropriate given monetary policy.

And normally the playbook says exactly what you said. You don't have to move till they raise rates. **The only nuance I would put is the market had a nasty setback after QE1 ended. Had a nasty setback after QE2 ended. Japan had a nasty setback after they ended QE.** ***[Emphasis ours – KS]***

And it makes it a little more complicated. Are we supposed to look at the papering after the first interest rate rises or the rate itself? I would say lean more toward the rate itself. Because even after we start moving, as you can see by the charts I just showed, **we are way behind. We are at once-in-a-century emergency levels. We've never had these rates before. But if you look at the 100 years of economic history, we're probably in the 40th percentile. We're not in the zero percentile. Do those charts look like 1932 or 1933 or 2008 to you?** ***[He is making the point that economic activity, while not robust, is still "humming along" while rates are at 100-year emergency levels; why? And what will happen when rates have to rise? Emphasis ours – KS]***

Mr. Druckenmiller is calling out the Fed for being far too easy and saying that when rates start to normalize back to more historic levels, we are liable to have a hell of a recession and market correction. And he doesn't even address the question of inflation…..

Kanos Quarterly Commentary

The Trouble With Debt

Debt is probably the defining element of our present day economy, mostly due to the ease of being able to incur it (on a historical basis AND at a reasonable price). Most people in the developed world seem to be very comfortable with debt: people have mortgages on their homes, often have debt as part of the capital structure of their business and in many cases seem comfortable running large balances on their credit cards. In addition, most people, while probably uncomfortable with the size of the national debt in countries like Japan, the United States, Italy, Spain and other developed countries, also don't seem to believe that such large debt balances are a problem that need resolution anytime soon.

Why are people so complacent about debt, both personally and communally? In our opinion, it is the influences of central banks worldwide that foster this complacency and worrisome lack of urgency of dealing with debts. In the United States, the Fed has exerted historically high influence on the economy and financial markets, lowering both the price of holding debt (the interest rate) and the risks of holding the debt (of sustaining losses through possible repurchases).

Interest rate suppression started (most recently) with Fed Chairman Alan Greenspan's "flooding the banks with liquidity" following the 1987 stock market crash. Easy monetary policy continued during the mid-to-late 1990s culminating with the Y2K flood of liquidity which helped fuel the 2000 stock bubble. To compensate, the Greenspan fed lowered interest rates to 1% (far too low) in 2002-2003, causing the housing/mortgage credit bubble which popped in 2007-2009. Finally, the low interest rate mantra continued with the Fed's last few years of unprecedented monetary easing in what many believe is now a relatively healthy economy. These episodes of "too low" interest rates, especially for the prolonged periods of 1997-2000, 2002-2005 and 2010-2014 allow people to take on debt at a very low "price" (interest rate). This easy money then finds its way into investments, including some that might not be successful with market-determined interest rates but are economic with low, suppressed rates. Thus, in the 1990s, people formed large businesses that didn't survive the dot.com bubble bursting and the resultant recession; in the 2000s, people bought "too much house" when interest rates (and purchase terms) were too low [for the risk] and investors bought the mortgage debt [in part due to sponsorship (homeowner promotion) by the Fed; and in the 2010s, governments (and individuals and businesses) have taken on increasing debt to support a standard of living not attainable without debt [and thus, by definition, unsustainable].

In addition, the Fed's repeated episodes of benign paternalism, or in more vulgar terms, bailing people out, has repeatedly led to the strong notion of the "Federal Reserve put option". The Fed put is thought to benefit the US economy as follows: when economic situations improve, people/companies/funds reap the benefits, but when things turn sour, the Fed is there to provide cheap liquidity (i.e. financing) to bail out the banks holding the loans or in some instances to actually buy the debt at 100 cents on the dollar, thus "making whole" the lending party, and allowing the failed/defaulted/potentially bankrupt party to continue in business. Just like with "too low" interest rates, this Fed largesse has emboldened people to invest (or lend to) ventures with high risk profiles which might not get financed in a more market-oriented environment. This has also led to distortions in the markets where capital is misallocated to marginal projects and, in many cases, drives down profit margins of even well-capitalized businesses in the same sector.

But what does debt do – fundamentally speaking? **Debt allows demand to be pulled forward**. One who does not have the money available is still able to purchase an asset by borrowing, thus allowing more money to be deployed. As long as the debt can be serviced, this allows capital to be deployed faster, thus allowing an economy to grow more quickly in the short term. Of course, on the flip side, if debt is too much (or too expensive, interest rate-wise) and a business fails, capital is destroyed faster, as equity in the business is destroyed and bondholders seize and dispose of the remaining assets, hopefully recovering their investment (or as much of it as they can).

What incentives do monetary authorities have to keep interest rates at such low levels for so long? Obviously, low interest rates allow cheap financing to encourage faster economic growth. But don't low interest rates for too long lead to inflation? In the past, low interest rates have caused inflation to heat up, causing prices to go up and squeezing people's standard of living as prices rose faster than incomes. However, since the financial crisis beginning in 2007/2008, the destruction of capital through debt write-offs has cancelled out (or consumed) the capital fed into the system as banks have gradually written off the bad debts stuck on bank balance sheets over the years. This destruction of capital, combined with the fall off in demand for goods during and after the crisis, moderated inflation in the 2009-2012 period. This allowed the Fed to keep easy monetary policy at a time of moderating inflation. Now that banks are more solvent and many bad debts have been written off, we would expect that banks will grow lending (according to Grant's Interest Rate Observer, Commercial & Industrial loans [through May] are up 13.5% through the last six months year-over-year), and increased lending usually leads to higher monetary velocity and could ignite higher inflation.

But the Fed has continually said they were going to be late to tighten – why? Although they profess that there is no inflationary pressures or damage being done to economic conditions, low interest rates keep borrowing at maximum levels to keep the economy growing, but **they also allow current debtors to refinance at low rates and the resultant inflation allows debtors to pay back debts with inflated dollars.** This, of course, is the dirty little secret that no one will admit to – that the US Government and the financial system are the largest borrowers in the economy, and inflation allows them to pay back debts with inflated dollars. This is obviously true in Japan and Europe, both with record high amounts of sovereign debts and overlevered financial and corporate sectors.

So, who is hurt by these present conditions? Obviously savers, who have put their money in the bank or fixed income assets trying to earn interest; with short-term rates at zero for years, any interest-bearing asset of less than two years essentially pays no interest, and **on a real (inflation-adjusted) basis, savers are losing money**. The Fed has obviously been supplementing banking earnings by allowing banks to borrow at near-zero percent interest rates, and allowing them to earn "carry-trade" profits of borrowing short-term and lending longer-term, either with bank loans or through buying bonds, even governmental bonds. **The other losers have been pension plans and insurance companies which historically have invested large amounts of capital in fixed income in order to generate income to pay retirees (pensions) or to pay insurance claims (insurance companies).** In the past couple of years, pensions and insurance companies have joined individuals in having to "reach for yield" (buying less-traditional investments to generate the yield that governmental and high-rated bonds used to generate). Pension investments have had to move to: 1) increased exposure to equities, 2) increased holdings of lower-rated bonds, 3) increased holdings of lower-rated foreign sovereign and corporate bonds, 4) alternative investments like MLPs and leveraged hedge funds, 5) levered debt structures like Collateralized Loan Obligations (CLOs) that are cousins to the CDOs that led to large losses in the 2007-2009 period.

So debt, in measured doses, is an accelerant for economic growth. Debt, as we found in the mid-2000s, can cause massive financial dislocations when accumulated in great quantity. We are afraid that while we don't see a repeat of 2008/2009 in the near future, we do see a time of higher rates in the future that will cause large mark-to-market losses in bond portfolios. As referenced early in this letter,

David Rosenberg of Gluskin Sheff opines that inflation starts in assets, then is visible in credit, moves on to the amount of lending, finally appearing in consumer prices and lastly in wages. We believe that inflation is in the fourth of these five stages, coming through in consumer prices currently, having inflated asset prices, credit and lending. We are fearful that the buildup in debt around the world will force central banks to stay far easier in their monetary policy than they would otherwise, fanning inflationary flames that could lead to serious bouts of inflation in the future. In addition, the buildup of sovereign debt far in excess of even the amount of the developed world's GDPs means that the debt can never be paid off and will be harder and harder to service as more debt is layered on and interest rates inevitably rise. Government services will eventually have to be cut, and politicians will try to raise tax rates (to attempt to generate more taxes, but may have the opposite effect of dropping tax receipts as higher taxes will discourage economic activity).

In our opinion, abandoning interest rate manipulation will serve to let markets set a balanced interest rate environment, where lenders and borrowers will price debt with more traditional economic metrics. Running balanced government budgets or at least limiting deficit spending to a limited amount and over a limited time will have to be implemented to try to slow down governmental debt accumulation. Obviously, allowing interest rates to rise and normalize, and cutting government due to budgetary constraints, will cause an economic recession/depression. However, "taking our medicine" while the amount of debt is potentially manageable is preferred to letting debt grow to the point where inflation (and pretty massive inflation) is the only way to "pay back" the debt eventually. We hope leaders will emerge that understand this.

The Managers of Kanos Capital Management
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