Third Quarter 2019 Investor Letter

Portfolio Comments

Kanos portfolios performed well during the third quarter as our defensive positions, led by our overweights in precious metal positions and defense holdings, pushed our portfolios higher despite the US economy's slowing growth indicators. Corrections in some defensive positions during part of September moderated our gains somewhat, but we felt this was short-term and our positioning was optimal for the autumn. We left most portfolios intact because they were working as designed: we are still positioned with a "barbell" approach of stock market exposure, balancing stock market "beta" positions/easier money beneficiaries with fixed income, precious metals and other defensive holdings.

Market Analysis - Looking Forward

Economy

The US economic growth slowed further during the third quarter but benefitted from a slew of last-minute activity due to the end of the US Government fiscal year in September, bouncing from a level of manufacturing not seen since the last recession in 2009. Looking forward, we believe the September glow will dissipate during the fourth quarter, with the weakness of the manufacturing sector of the economy pulling down the rest of the US economy slowly. We had a preview of this when Retail Sales for September showed the first drop since February, falling -0.3% compared to a +0.3% increase expected. Industrial production also fell in September, by -0.4% versus the -0.2% expected, hurt most by a -0.5% fall in manufacturing output; these results are concerning because they include a buildup in inventories that preceded the mid-month strike at General Motors. Manufacturing output is down -0.9% year-over-year (yoy), showing the extent of the slowing of US manufacturing. Finally, the Index of Leading Economic Indicators dropped unexpectedly in September (by -0.1% when it was expected at +0.2%) and was revised downward for August from 0% to now -0.2%, meaning the index has now dropped two months in a row. Many economists see a three-month losing streak for the LEI Index as another indicator for a recession in the coming months. All of these indicators point to further slowing in the economy.

The sector surveys that have caused the most angst in markets, the PMI/ISM surveys that gauge professional sentiment in manufacturing and non-manufacturing industries continue to be the primary gauge the market is using to measure the slowing of the US and world economies. The Fed's October meeting produced the expected -0.25% rate cut, premised by Fed Chairman Jerome Powell as "an insurance cut" that was meant to help conditions mostly in weaker overseas economies that use US dollars and dollar interest rates.

Thus, these recent economic results confirm for us the slowing of the economy. We think tariffs have played a negligible part in this slowing, as the imposition of tariffs (and the incumbent raising of prices that usually accompany it) should lead to a burst of import buying pre-tariffs, as many new tariffs are scheduled to go into effect in mid-September/early October. Instead, with falling retail sales and leading economic indices, we don't really see this. Exports only make up around 2% of US GDP, so they are of small effect on the economy, but we think we would see increased shipping and selling of exported products before foreign imposition of tariffs (retaliatory or otherwise). We haven't seen that either. In fact, industrial production has been driven by continued increases in US utility production, meaning the US is using more energy and power, while energy prices and industrial output has shown weakness. We are worried about demand continuing to erode and the economy slipping further due to overcapacity and increased price competition to retain market share across several industries.

In Europe, Germany is now officially in recession, with economic growth negative for the second quarter in a row, further confirmed by their ZEW sentiment index printing -22 for the last two months. The rest of Europe has slowed but is not in recession, at least not yet. We don't see an engine for growth at this point, so we believe European Union economies will slowly follow Germany into recession. The UK is wrestling with the uncertainties around its exit from the European Union, but its economy has held up, not so far entering recession.

In Asia, Japan and China have shown continued deceleration in growth in their economies, with Japan near zero growth and China's 6.0% GDP growth the lowest in more than two decades. China's deceleration is partly due to its industrial production dropping to a +5.8% growth rate, the slowest in years. Obviously, the tariff "cold war" with the US, where both sides have engaged in verbal jousting, threatened tariffs and retaliation and on-again/off-again negotiations for a trade agreement have hurt the Chinese export economy, notably in US exports. A trade "outline" was agreed to last week by the US and China, but we don't think that will lead to a renewed growth spurt in either economy, although a thawing of trade tension could allow for trade thought to be lost to be reestablished between the two, leading to slightly higher growth. Chinese official PMIs for October were reported out right at press time for us, and they were just above or at levels not seen since 2009, so obviously corporate managements are growing even more pessimistic. Thus, we think trade will slowly pick up between the US and China as partial trade pacts are agreed to (due to necessity) by both sides, but the long-awaited "final agreement" will not be "assembled" into a full agreement at least until 2021.

Emerging markets are the only place in the world with economic growth, but this growth is the slowest in years. The International Monetary Fund (IMF), at their annual meeting this month, cut 2019 world growth for the fifth time to just 3.0% (which includes China's 6.0% growth), in which 90% of the world's economies will see slower growth. The IMF also said monetary policy was near the end of its rope, with many developed countries having negative rates and other large countries (namely, the US and China) actively cutting rates, with little actual room to cut much further. We actually think emerging market economies will hold up better than developed market economies because they have received less monetary stimulus and have less overbuilding / overcapacity. Also, investment in commodities has been at a bare minimum or less for the past several years so, at some point, commodities may start to show supply constraints, giving producers some pricing power again, which could help a lot of emerging market countries (more on this below). However, investor sentiment for emerging markets is currently

near lows, and with a relatively high US dollar, there is little appetite for investment in emerging markets by US and European investors. Thus, we will continue to be underweight investments in these countries.

Equities

Having observed the economic slowdown reiterated above, we are still a little surprised at the resilience of the US stock market. We believe the majority of the strength is due to: 1) continued belief that a thaw in US-China trade relations (with some kind of trade deal, no matter how small) will rejuvenate both US and Chinese economies, 2) the 2019 economic slowdown will be followed by a reacceleration of world economies, similar to how the 2015/2016 slowdown-then-recovery occurred and 3) the continued large inflows into equities by the corporate sector (buybacks) and passive money investment by individuals. We came upon this very interesting table (below) from Goldman Sachs Research via ZeroHedge article "Hedge Fund Trader Who Called 2008 Crash Lists 3 Biggest Threats to US Stocks", October 13, 2019:

Exhibit 4: Corporations are the largest source of equity demand
as of 4Q 2018

	Net US equity demand ($ billions)				
Category	**2014**	**2015**	**2016**	**2017**	**2018**
Corporations	**$ 442**	**$ 508**	**$ 697**	**$ 296**	**$ 509**
Foreign Investors	114	(191)	(188)	125	(94)
Pension Funds	(272)	(7)	(217)	(162)	(243)
Mutual Funds	95	58	(112)	(134)	(124)
Households	95	(138)	(151)	226	191
Life Insurance	(5)	31	98	(45)	(18)
Other	12	(7)	(12)	(17)	9
less					
Foreign equities bought by US	432	197	22	167	128
Credit ETFs	50	57	96	123	100
Included among holders above are:					
Equity ETF purchases	$ 191	$ 174	$ 188	$ 347	$ 210

Source: Federal Reserve and Goldman Sachs Global Investment Research

As you can see, by far the largest buyers of equities are corporations, which are corporate buybacks. In 2018, they amounted to $509 billion and in 2019 are expected to exceed these numbers, maybe even surpass the $697 billion in 2016. Also notice the 'Households' line, where buying has been strongly positive in the past two years shown. This also illustrates the exit from active management - 'Households' and 'Equity ETF purchases' (at bottom of table) are strongly positive while 'Mutual Funds' buying has been negative, showing a move out of Mutual Funds to ETFs by Households.

The Fed has continued to drive behavior in the equity markets with the progression of rate cuts, the establishment of repo financing facilities to provide increased liquidity (more on this below in Kanos Commentary) and finally the re-introduction of Asset Purchases, the functional equivalent of more quantitative easing (but which Chairman Powell firmly disavows calling quantitative easing). Chairman Powell and the FOMC introduced the new asset purchases to provide liquidity and for banks' reserves/balance sheet management, with outright purchases to occur at a $60 billion/month pace (and the first few purchase sessions being 4x oversubscribed), this is almost exactly the same as QE3, albeit with an end date (QE3 was famously open-ended). The liquidity from these purchases has had some of the intended effect on bank reserves (there is still ongoing demand for more liquidity). But we have seen more effect on the stock market, with indices rebounding and sentiment raised, as "muscle memory" from the early 2010s quantitative easing rallies is taken up by present-day equity market participants. We believe as long as the Fed continues to "up the ante" on stimulus, the equity markets will be buoyed. At its late October meeting, The Fed cut rates again, as expected (most probably due to the fall in retail sales and industrial production). The Fed's moves have kept the stock market from falling much, and this strength has translated into marginal new highs.

The other element to be reckoned with is corporate earnings. Third quarter earnings are currently being reported, and earnings growth is expected to be roughly flat. However, winners and losers are experiencing large gains and losses, respectively, showing increasing investor nervousness to be invested in winners and selling companies with earnings disappointments quickly.

With all that in mind, we will continue to be mostly invested, with our concentrations in defense (working well), precious metals (correcting after a torrid summer run and looking bullish again), REITs, utilities, and pharmaceuticals (all consolidating their gains from earlier in the year, while paying us in dividends to be patient) along with large energy companies (weak, but their integrated nature allows for better earnings due to balance of sectors) as well as some technology and consumer companies.

With a still high US dollar and slowing international economic growth, we are still shying away from both international developed and emerging market stocks (for the most part). We believe growth prospects in domestically listed companies tend to be better, but we are starting to look at selected international opportunities as dollar strength starts to wane somewhat going forward.

Bonds

Bonds are a bit more of a quandary right now, as economic statistics point toward further weakness, but monetary policy and renewed equity market enthusiasm have led to some disinvestment in bonds and higher rates in the long end, un-inverting the yield curve. As stated above, we are skeptical of an engine of growth for developed world economies right now, so we don't want to sell any of our bond positions. However, we are also not looking to increase our bond exposure because we already have healthy exposures.

International bond markets are easier to explain. Most European government bonds yield far less than US bonds or are negative yielding, making them unattractive for us. Asian bonds, while possibly attractive, have too much currency risk for us at this time, and Chinese securities are increasingly coming under more scrutiny due to the uncertainty of some of the financial results, especially anything state-run.

We still see rates moving lower over time, so we may look to beef up fixed income positions in the future for accounts that are under-allocated, but until there is more evidence of flagging of investor enthusiasm for equities, we will stay with our current allocations.

Currencies

The US dollar rallied during the quarter, hurting US competitiveness and emerging markets ability to buy US exports. October has led to some weakness in the dollar, but not enough to change the strong dollar regime yet.

We do not see currency situations changing much for our investment situations until we see the dollar either go to new multi-year highs or start to break down.

Energy

Energy continues to exhibit horrible investment sentiment, as oil prices touched 2019 lows of just over $50 again during late September. We have not been bullish on oil in a while, but we were surprised at the relatively muted reaction to the attack on Saudi Arabia that took out 5+% of the world's oil production. After a multi-hour pop in prices exceeding 20%, oil prices fell all the way to the low $50s/bbl, a level lower than just before the attack. Considering investors continue to hold up equity markets due in part to economic reinvigoration forecast for the near future, we would have thought the need for more energy to power this forecast expansion would keep a bid in oil – it has not so far.

We feel that the attack and its fallout going forward, coupled with the growing financial problems in the US shale oil patch limiting any further production gains, will at least put a floor under oil prices in the next few months. The attack on Saudi Arabia was impressive technically: a relatively low number of low-flying remote missiles/drones did major damage to the most important crude oil processing plant in the world and the second largest oil field in Saudi Arabia. While the Saudis have professed that they are back to normal levels of production, we (and a number of experts in the field) believe that "fixing" the damage will take months, requiring design, manufacture, delivery and testing of replacement equipment before operations will "return to normal," as currently claimed by Aramco. Most probably, the Saudis are drawing down their storage and rationing domestic energy somewhat to maintain delivery levels. This will eventually become no longer doable at some point in the near future.

For shale producers, the debt raised or refinanced after the 2014 oil price fall is starting to come due, beginning this year. Unfortunately for many indebted producers, the constant productivity gains realized in the early 2010s have not been maintained, and planned in-fill drilling of prospects (by drilling

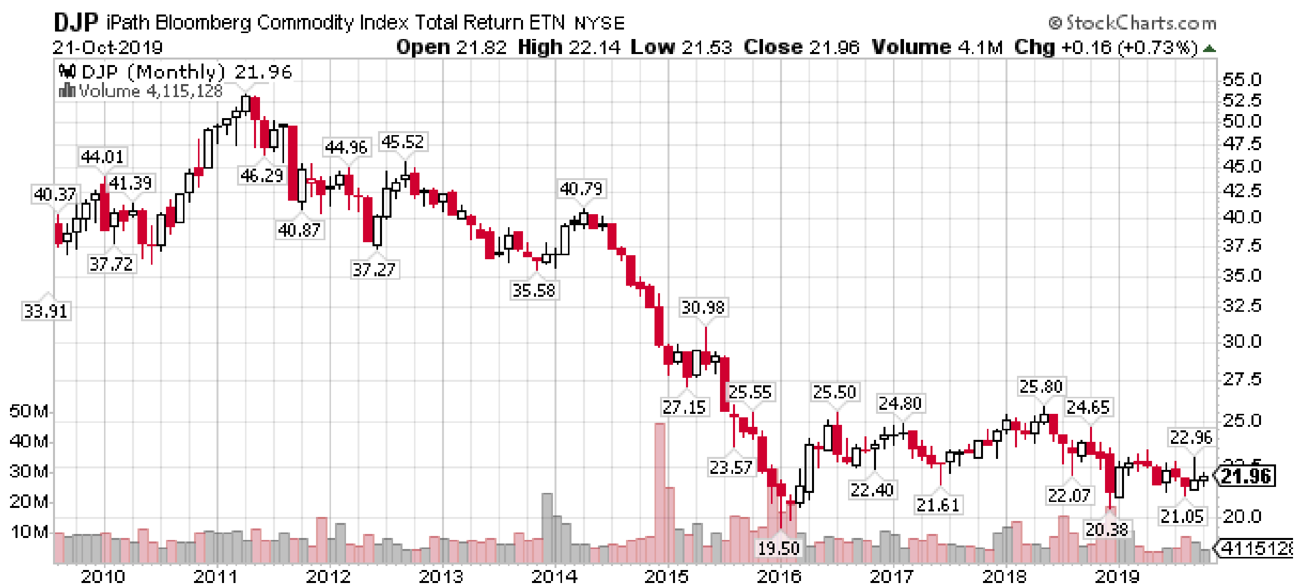
KANOS
CAPITAL MANAGEMENT, LLC

wells more closely) has turned out to be counter-productive ("daughter" wells stealing forecast production from earlier wells in the area). This has led to worse than predicted production levels and well lifespans, making debt payback more difficult. Thus, a large number of shale producers have sought either 1) to sell properties or the whole company, 2) a merger with a larger partner or 3) more financing (sometimes in different forms, like production bonds), which is harder and harder to come by. Many firms have already succumbed to bankruptcy court, and absent higher prices soon, more are expected to go bankrupt. As this process plays out, we see production topping and industry discipline becoming stronger.

These thoughts continue to support maintaining a position in energy equities, which we think are best limited to the supermajors. We like the financial heft, the diversified operations (both upstream and downstream), the dividends and the geographic diversity. In a more defined rising-price environment, we would look at well-run independents as attractive ways to invest in energy.

Commodities/Precious Metals

Commodities in general (agriculturals, base metals, energy), and precious metals specifically, have been on very different courses lately. Commodities, as represented by the Bloomberg Commodity Index (the ETF which mimics the index shown below) bottomed in late 2015, and after recovering in 2016, went sideways for two years before going back down near the lows in late 2018, advancing only slightly since then. Some analysts have observed that many commodities are at or near their marginal cost of production, meaning that these price levels are probably near their lows as commodity operations have seen underinvestment in the last few years.



In contrast, precious metals prices based for three years after hitting their multi-year lows in late 2015, only to turn up in 2019. Gold, reflecting uncertainty in the world financial systems, has outgained

general commodities since then, advancing during 2019 despite strength in the US dollar, weakness in commodities and a stock market hitting new highs as late as July. Gold's summer breakout and subsequent 22% gain led the whole precious metals complex higher during the summer, and since late August, the complex has been consolidating and correcting those gains.

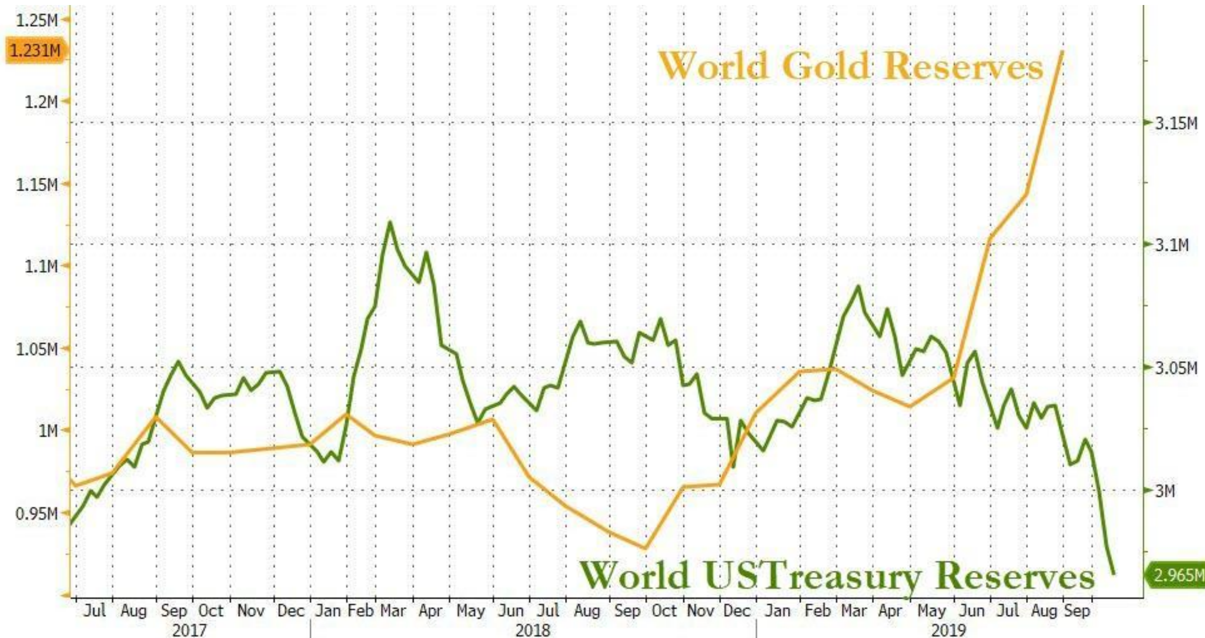
Fundamentally, the underpinnings of the precious metals rally are still very much intact: loose monetary policy around the world getting even easier as central banks restart quantitative easing-type monetary policies, falling mine output, growing political uncertainty and rising geopolitical tensions on most continents around the world.

Technically, gold looks set to resume its upward movement in the near future. As seen in the chart below, the gold price is consolidating after a strong upward move. As shown originally in The Gartman Letter, gold seems to be forming a third "bull flag" pattern in which prices correct in a downward sloping channel (as marked by the blue lines) until the price breaks out to the upside (as it did in October 2018 and May/June 2019, see the left and center channels in the chart below).

We have seen the gold price continually resist moving down strongly since the recent mid-September low at $1465/oz. The Fed has continued its easing ways at its late October meeting, lowering rates 0.25% again, and the government continues to spend money at the rate to incur another $1 trillion deficit. Gold has moved up to the upper bound of the flag structure, which we think will lead to the next advance in the next few days/weeks.

One final note: central bank purchases of gold have continued apace, underpinning the gold rally. Interestingly, Germany's central bank, the Bundesbank, bought gold in the open market for the first time in 21 years, reversing its stance of selling gold every year since 2001. Now that the Germans have started buying gold again, maybe we should all be concerned! (Since they have been a consistent seller for so long, including before, during and after the 2008/2009 financial crisis). They join a number of

other central banks adding gold at the expense of US dollar reserves, as seen in the following chart from 10/23/2019's ZeroHedge article "The End of Fiat in One Chart?":



In our portfolios, we will maintain our gold and gold-mining investments, mixing newer growth investments with some of our long-owned higher reward value plays like Yamana Gold and Detour Gold. We may weigh expanding to well-financed smaller companies when gold breaks out once again.

We are still interested in US agricultural commodities. Attractive fundamentals (yield will be much lower than thought – meaning supplies are tighter than thought while demand continues to be strong) in soybeans, sugar, cotton and coffee continue to be on our radar screen as possible investments. They all have ETFs in which to invest in stock markets if we determine that the opportunity looks very attractive.

Kanos Quarterly Commentary

Curiouser and Curiouser

As I was considering the subjects that we might examine in this quarterly commentary, I couldn't get over the fact that there are a lot of things occurring in worldwide financial markets and political arenas that are downright hard to explain and even harder to interpret in real time. Each is unique, at least in the last decade, so I thought I would take a stab at a few of them, giving our firm's interpretation of what is happening and what it might mean to you and your money.

As the title implies, a number of happenings around the world seem particularly unusual, so much that it reminded me of the old Alice in Wonderland quote: "Curiouser and curiouser!" Cried Alice (she was

so much surprised, that for the moment she quite forgot how to speak good English). It is particularly poignant because a number of commentators in the US financial markets, notably our colleague Michael Lewitt who writes the critically-acclaimed monthly newsletter "The Credit Strategist," has described this market as the "Alice In Wonderland" market, since it has exhibited a number of elements that seem like they are backwards, made-up or just plain wacky.

Negative Interest Rates

We will start with negative interest rates, even though they have existed for a few years already. As we know, negative interest rates were caused when bond buyers, most notably in Europe, bought bonds, bidding up their prices to the point where the amount to be returned to the buyer was less than was paid for the bond. Now, European governments, some corporations and even some "junk" rated corporations, have issued new bonds in which the promised stream of payments and ultimate repayment is less than the price paid initially for the bond. So, what of it?

Negative interest rates are an anathema to the workings of a healthy economy. Healthy economies put capital to work in the hopes that it will earn an attractive rate of return. In some cases, this means taking more risk and investing for equity-like returns (along with increased risk or at least volatility). In other cases, it means finding a less risky alternative like a bond in which the risk being taken is offset by a return on the capital, often relatively low (like investing in a government bond, which often entails the least risk in financial markets). However, the risk of political upset, a coup d'état, poor financial management, increasing inflation, etc. means there is always some risk, especially in a fixed income instrument, even if investing in a supposedly "safe" government bond ("safe" really only applying to credit risk, not interest rate or inflation risks). A negative interest rate means the **investor is paying the borrower** to use his money for the specified duration of the bond. If a country is in financial depression and investors feel the need to "park" capital in government bonds because of the risk of collapse of most other investment possibilities, negative rates might exist for a limited period of time. But otherwise, why would anyone invest in a bond that you must pay to own? **There are currently estimated to be $15+ trillion of bonds outstanding that are currently quoted at a negative interest rate! This includes Greek government debt, which they recently sold at a slight negative yield, just a few short years after being saved from bankruptcy by the European Union.**

There must be some large force acting on the European bond market here, and of course, that is the case. The European Central Bank was afraid of deflation after the 2008 Financial Crisis and the subsequent 2010 European Debt Crisis, so it decided to provide a large monetary stimulus program to Europe to revive economies. The ECB was the original large buyer under its quantitative easing program (of the past few years) that bid for European government bonds at higher and higher prices so that the effective yields on those bonds went negative. Since the initial program and waves of buying, governments and corporations, as mentioned above, have issued new debt at negative yields. The ECB bought bonds at higher and higher prices to re-capitalize European banks, which were facing insolvency due to a large number of outstanding loans to insolvent or soon-to-be-bankrupt companies following the 2008 Financial Crisis and the subsequent 2010 European Debt Crisis. Boosting liquidity by exchanging government bonds for currency helped banks to continue to function. This bond buying also allowed banks to realize profits on their bond portfolios, helping restore some profitability. Subsequently, the

ECB lent at lower and lower (and then negative) interest rates to allow banks to borrow at zero or negative rates. These historically low rates are a complete subsidy – the central bank pays the bank to borrow money, and this payment is created money, conjured out of thin air – to further help banks to maintain an attractive net interest margin, their "bread and butter" profitability engine. These measures were deemed necessary by the ECB to save and keep alive the European banking system, but in the medium-to-long-term, can it really do such?

Banks generally make money through taking in deposits and borrowing cheap money in the money markets, and then lending that money out longer term and generally at greater risk, charging a higher interest rate than paid out to depositors or short-term lenders. With negative rates, the bank must pay the borrower to take the money! It is easier to imagine with a (2017 real life) example: a Swedish woman (Sweden's short-term interest rates are negative) went to borrow money using an adjustable rate mortgage. She was approved by the bank, and her interest rate, based on short-term rates at the time, was -0.10% - the bank sent her a small check each month for "the interest due on her mortgage!"

Negative rates mean the bank pays the borrower to take the money and tries to get paid **more** from those lenders lending to the bank (i.e. the central bank) or charging large fees to depositors for depositing their money in the bank. Central banks may pay these high fees for a time, but at some point, they must feel that they no longer need to subsidize the banks. And certainly, depositors will revolt about paying large fees for keeping their money in the bank; at the very least, people could keep their money in cash, thus avoiding deposit fees and depriving banks of a very large and valuable source of capital for lending. Ultimately, without central bank subsidies (or in reality, central banks acting irrationally) for as long as negative rates prevail, the negative-rate regime ends up **bankrupting banks**, who cannot source cheap enough funds to make an adequate net interest margin to support the banks' cost structure and return for the owners. This can be seen in the price of Deutsche Bank, the largest bank in Germany and Europe, down more than 93% since its 2007 highs.

<u>The Issue:</u> Are negative rates "necessary" going forward, and what can be done so that they are no longer needed?

<u>Possible Solutions:</u> So, what can be done? There are a few possible solutions: 1) "Nirvana" - economies can start growing again, where demand for money incentivizes higher (and positive) interest rates again. This, of course, is the optimal goal, but growth and demand continue to flag in Europe and Japan, 2) "Let It Go" – if the ECB stopped buying bonds, rates would probably go up and the price of bonds and loans go down as the biggest buyers, the ECB and BOJ, ceased buying bonds. However, if the ECB wanted to end negative rates, it needs to stop outwardly "charging" negative rates and move to a 0% overnight funds rate. This would mean interest rates would move up 0.50% or more (since the overnight rate is currently -0.50%), which would be a negative shock to the financial system, holders of fixed income securities and, probably the whole European economy. It would also mean capital losses for all holders of those bonds and loans, most notably the banks, which will have to write off large amounts of value, most probably rendering many or most of them insolvent. This solution will require a rescue/bailout by governments and/or central banks, and a recapitalization of the banks and banking systems. This scenario is probably what "should" have happened in 2010 and onward, but the EU authorities were unwilling to take these steps, preferring to give "strong medicine" (or possibly poison, depending on how you look at it) to the financial system and hoping this financial stimulus would help growth resume in the economy. Now this solution is pretty much impossible to implement. The other possible solution is 3) "Force It More" – try to renew growth in European economies, almost certainly with fiscal stimulus from governments, that hopefully will then generate such demand for capital that interest rates can rise to positive levels through regular economic growth channels. While the first and third scenarios are possible, the extent and growth of negative interest rates is so large that it seems like economic growth that would be large enough to pull interest rates up is truly something out of "Alice in Wonderland."

The US Repo Market and "Not QE"

As we all know, the Fed bought Treasuries and mortgage debt through a number of rounds of quantitative easing (QE) starting in late 2008. The Fed bought around $4 trillion in bonds over time, which resulted in a Fed balance sheet that topped out around $4.5 trillion but was later run off starting in 2017. During the time the Fed was running QE, Congress was investigating and passing laws to try to prevent the banking crisis at the heart of the 2008/2009 financial crisis from happening again. Ultimately, the Dodd-Frank Act (Dodd-Frank) was passed that required banks to maintain greater reserves and exit the banks' large inventory of financial instruments, which severely limited the banks' ability to trade for their own accounts and limited banks' holdings of outright positions. When there were tons of Fed-provided liquidity, these large changes to the system didn't affect daily financial operations.

However, as quantitative tightening (QT), the opposite of QE, was started by Fed Chair Yellen and accelerated through 2017-2019 under Chairman Powell, the withdrawal of reserves from the system started to produce some unexpected results. The "repo" market in the US, which is one essential part for the functioning of the financial system, started becoming "tighter" despite the authorities' expectations.

A "repo" is a Repurchase Agreement in which one party with an asset, for example, a Treasury Bill, borrows cash and pledges the T-Bill as collateral. The cash lender (for example, a money market fund) lends the cash, receives the collateral, and at maturity, the borrower (for example, a mortgage REIT) pays back the lender the principal and a small amount of interest (after which the lender receives back his collateral, too). This happens for many different maturities, from overnight to 2-day, to one-week, one-month, three months and sometimes longer. It allows institutions with lots of assets to borrow cash on a short-term basis and not have to sell assets. It also allows entities with lots of cash (for example, big banks, cash rich corporations, money market funds) to invest overnight or short-term in a liquid market and earn interest. Borrowers include banks (temporarily short on cash), bond funds, mortgage REITS, non-bank financial institutions, etc. Large "mega-banks" typically facilitate the market by borrowing the cash from the cash lenders and lending the repo cash to the borrowers, taking a fee. Many times, smaller banks, when faced with a shortage of cash overnight, will simply use the repo market to obtain cash for the short term until their own cashflows replenish their cash balances when they pay back their repos.

The repo market is large and liquid and transacts first thing in the morning when money market funds look to invest their cash and borrowers calculate their daily cash needs and go into the market to borrow them. As QT took more and more cash out of the money markets (QT involved the Fed either selling or letting roll off its Treasury and mortgage bond holdings, which took cash from the system), the repo rate of interest, which is generally around the Fed Funds rate (the rate at which the Fed lends to banks to maintain reserve and interest rate levels), began to rise, staying at a slightly higher level than the Fed funds rate (and the rate the Fed pays banks on their reserves held at the Fed, the Interest on Excess Reserves or IOER). **Since there were supposed to be as much as $1.5 trillion of excess reserves in the banks, why would the repo rate be higher? Banks should just arbitrage the higher rate, pulling out some of their excess reserves from the Fed and lend at the higher rate into the repo market, doing so until the rate dropped back into the "proper" range. But it didn't happen in July and August, and on September 16th, the rate skyrocketed to 8%, when the normal range is in the 1.90-2.00% range. What happened?**

The explanations being put forth are that third quarter taxes from corporations were due on the same day when Treasury borrowing was higher than normal, both of which would require cash from the financial system as a whole. However, these are typical happenings that occur frequently and are easy to plan for, why was there outsized demand for "typical" occurrences? More concerning is that elevated borrowing needs continued, causing elevated yields (2.00+ to 2.50%) to be continually seen daily in the markets afterwards. The Fed quickly noticed, and it immediately stepped in to provide a "repo borrowing facility", in which it provided up to **$75 billion per day** until stability was restored. Its results? $53 billion were submitted (and accepted) the first day, but on the second day of the facility (September 18), $80 billion in bids were submitted, more than maxing out the $75 billion available, and on September 19th, $82 billion were submitted, again swamping the already large repo facility. Early the next week, submissions for repos ranged from $65 billion to $91 billion, outstripping the facility again for two days.

The Fed and industry also realized that there might be a problem at quarter-end (September 30) when financial institutions typically want to hold more cash to make their financial statements cleaner. Thus,

the Fed decided to institute a "term repo facility" that would lend additional cash into the system for a two-week period, which would span the quarter-end with days to spare. The first term repo was held on September 24th for $30 billion, and **$61 billion in term repos were submitted!** The issue that was supposed to be a Monday liquidity "snafu" had now become a $135+ billion liquidity scramble, and no one was really coming forth with any good answers why. In the last days of September, the daily repo facility ended up being used less, but the next two term repos were highly subscribed, with capacity at $60 billion for each auction and $72 billion submitted on September 26th and $50 billion on September 27th. The quarter ended and the fourth quarter began; issue solved, right?

Wrong. Early October daily repos submitted ranged from $30 billion to $62 billion, while term repos during the time ranged from $20 billion to $42 billion for a $45 billion facility, nearly maxing out twice. What was the reaction? Inter-meeting Fed conversations and conference calls (rare events in the past few years) which established what the Fed is calling a "new reserve management program" in which **the Fed will buy $60 billion of Treasury bills each month for the next six months, starting immediately. Except for the rationale put forth by Fed Chairman Powell, this is virtually identical (although 25% smaller) than QE3. When announcing it, Chairman Powell insisted that this was "not QE".** We are left to find a name for it, but we are going to use what ZeroHedge calls "POMO" or Permanent Open Market Operations, in which the Fed buys T-Bills, which injects cash into the banking system, and plans to keep them on their balance sheet for the foreseeable future.

The Fed feels like they solved the "issue" with a combination of daily, semi-monthly and permanent liquidity programs. How have they worked since the October 11 announcement? "Problem not solved:" the daily repo submissions have ranged from $55 - $85 billion, oversubscribing one day; the Fed has made it a $120 billion max from October 24th onward. The term repo submissions have ranged from $20 - $52 billion for the now $35 billion facility , with the late October term repo oversubscribed by more than $15 billion. The POMOs have been done twice a week, for a $7.5 billion purchase each time: these have been wildly oversubscribed, with submissions **starting at $32 billion for the first purchase and almost $42 billion tendered for the late October one, with each purchase time being many times oversubscribed.** This avalanche of liquidity has allowed rates to stay at their expected levels, since the Fed has set the liquidity availability at such high levels.

So, belatedly but at least expediently, the Fed has determined that the US financial system has a liquidity problem, and while thought to be first, a snafu, and second, a quarter-end problem, it now seems a to be a too-tight reserve problem. But is that it? This reserve shortage is particularly concerning because it is basically unexplained why it's happening, and the Fed is delivering stronger and stronger medicine with essentially no explanations. **Banks are either unable or unwilling to deploy the more than $1.5 trillion in what were until recently thought to be excess reserves, and somewhere between $100 billion and $200 billion of Fed liquidity injections are barely covering demands for cash.**

The Issue: There are two issues: 1) why are previous excess reserves now more than $100 billion too little to satisfy US interbank / repo markets demand? And 2) why did the Fed essentially restart QE between meetings (very rare for any new policy to be implemented inter-meeting) at such a large rate and with little fanfare; is there something they know that we don't (and are not telling us) or, probably even more concerning, do they not know what is causing the situation?

<u>Possible Solutions:</u> Both issues are concerning, especially because of the Fed making its decisions so quickly and doing so between meetings. The reserve issue is obviously solvable with lots of Fed liquidity, but it is concerning that it was not anticipated and appears to be getting worse (more and more liquidity being requested). The fact that banks with excess reserves either won't or cannot lend to use the excess reserves already in the system is the biggest unknown. The Fed has stated and acted like it wants to influence the financial system less than in the past; this situation, while fulfilling their ultimate mandate of providing liquidity to deter financial accidents, re-inserts them into the heart of the US financial mechanics.

As far as the POMOs or the "Not QE" purchases, some have said the Fed was forced to move when Japanese liquidity was drying up as the BOJ has recently instituted a policy to try to steepen their yield curve by cutting the amount of purchases of longer-term Japanese bonds. It is said that this flow was large, and by cutting the amount, world money supply growth was cut, resulting in either tighter monetary conditions worldwide or another central bank replacing the BOJ in growing the money supply, which in this case was the Fed. This explanation seems a little farfetched to us, since Fed speakers over the past few months have mentioned that the Fed would not hesitate to restart "purchases of debt" if events called for it. However, Chairman Powell's explanation of "reserve management" seems thin or even evasive, especially to justify a permanent injection of at least $360 billion (or about a 20% increase in excess reserves) into the US financial system that is widely praised as having "fortress balance sheets" post-financial crisis.

Unfortunately, the only real solution is the one currently being performed by the Fed. Large banks, most notably JP Morgan and its chief, Jamie Dimon, have called on Congress and the Administration to relax the enhanced liquidity rules put into place after 2008; they argue that the banks are solid and should be able to lend their large amounts of liquidity into the market to take the place of Fed liquidity facilities. This solution actually did occur on a limited basis in 2015/16, so a re-emergence of liquidity problems in the market is, again, concerning. It appears pretty obvious that banks saved from insolvency in 2008/2009 by the Fed and supported for years by centuries-low interest rates mandated by the Fed should not have regulations relaxed as the economy slows and recession signs have appeared in recent months.

The other "solution" is that the Fed needs to do a much better job of calibrating "steady state" reserve levels needed to maintain a stable banking (and overall financial) system. That is the Fed's ultimate job, at which it seems to have failed miserably this fall. Reclassifying "excess reserves" that are needed for regulatory reasons and better understanding non-bank cash needs are a must for a better understanding of cash management in the repo, Fed Funds and other daily liquidity markets that keep our financial system running. **<u>Finally, the POMO/non-QE intermeeting institution seems to be a tacit acknowledgement of the Fed's overtightening of reserves. However, this non-QE already seems to be having unintended consequences as US equity markets have been on a nearly uninterrupted march upward since the buying began, contrary to many economic statistics that have shown the economy as a whole and a number of companies earnings announcements exhibiting the effects of a slowing US (and world) economy.</u>**

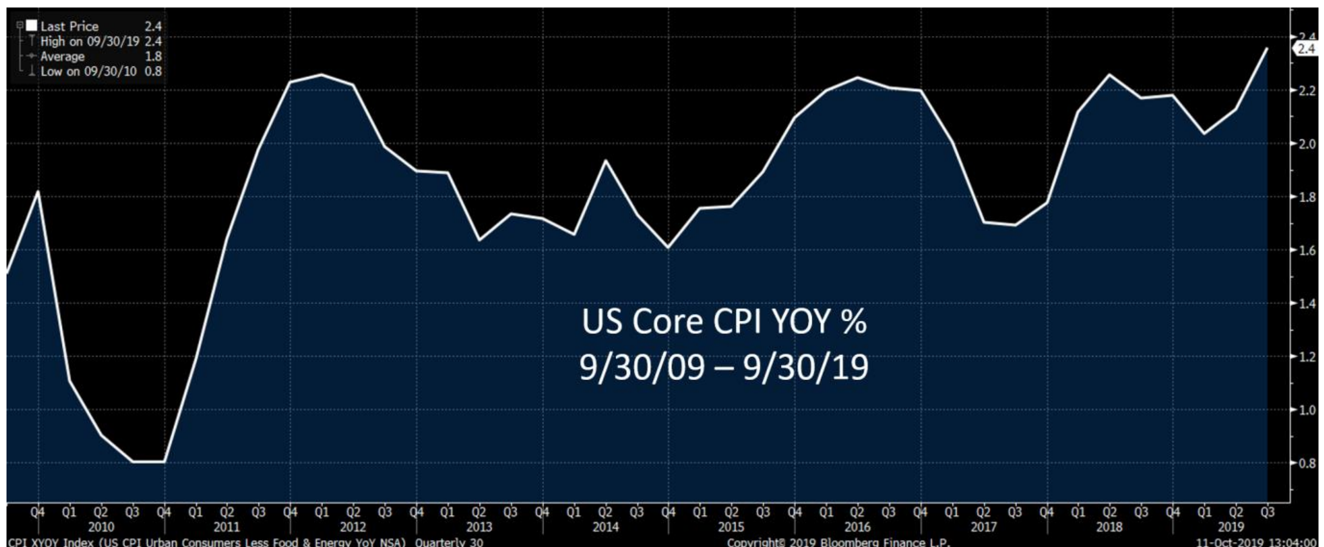
KANOS
CAPITAL MANAGEMENT, LLC

The Re-emergence and Denial of Inflation

As long-time readers know, our thoughts about the eradication of inflation (or any advent of deflation) border on the skeptical. The Fed (and almost all other central banks) has a long-standing policy target of 2% inflation, meaning prices are targeted to double every twenty years. Not achieving the 2% target does not constitute deflation or even disinflation (unless the inflation rate were to drop near 0%). But it hasn't.

Ben Hunt, a hedge fund manager and writer of a financial blog known as Epsilon Theory, helped put it best in an October 11 article on EpsilonTheory.com titled "The Common Knowledge of Inflation," where he emphasizes that the financial status quo has adopted the narrative that "inflation is low or non-existent," because it serves the purposes of the financial system and government to not worry the populace that prices might be going up again, making it harder to sustain lifestyles.

In the article, Mr. Hunt references a mid-October article on the financial website MarketWatch which references some recent inflation statistics, where inflation is rising but "less than expectations," leading the writer to communicate that there is only low inflation and room for further stimulus in the economy. Most economists and financial market participants use "core" inflation (which doesn't include the more volatile energy and food sectors); they feel it gives a smoother indicator of trends. So, here is the latest read on core inflation in the US in graphical form from Mr. Hunt's article:



<u>**Core inflation in the United States is now at a ten-year high, reading 2.4% (above the Fed target for the past few quarters)!**</u> And it doesn't seem to be trending downward either. But that is not the message we are getting, although I think most people "feel" this inflation. When asked about it, most people say "inflation's low;" it's what we've all read and what the Fed tells the financial markets. But, in real life, we see it all around: event parking that is $2 more than last time, sports and concert tickets are higher each time we have to buy them, medicines cost more, restaurants with new menus (meaning they've reprinted

them with higher prices), etc. There is inflation around, but it seems that no one is addressing it as a concern.

Inflation seems to be a much larger problem overseas: In Santiago, Chile, protesters destroyed a subway station with fire (photo below) and clashed with riot police (bottom photo, both photos courtesy of Sky News article "Army on streets after protesters set fire to Chile metro stations," on October 19). **This widespread violence occurred due to a pending 4% rise in prices for metro rides!** This shows how inflation can eat away at living standards until people become upset and lash out.

In Germany, at least one reaction has been different. The city of Berlin's governing parties agreed to pass laws that **freeze rent in the city of Berlin for five years!** The initiative was put forth by the Left Party's Katrin Lompscher but approved by the city legislature governed by the majority Social Democrats, the right center party that runs much of Germany currently. This mirrors New York State's Housing Stability and Tenant Protection Act of 2019 which expanded rent control, most notably in New York City. These are also reactions to inflation, but in this case, they are artificial controls which attempt to stop or at least slow down inflation. Why would New York and Berlin need to implement rent controls if there were no inflation and hadn't been for years?

Obviously, there is a disconnect between reality and the message we are being "fed." The reaction we must have is to ignore the message and to try to protect ourselves from the ravages of inflation, at least in our investment portfolios.

The Issue: We are being told there is no inflation and policies are being pursued that not only don't address inflation, they may contribute to more inflation.

Possible Solutions: The solutions are to try to avoid or protect against inflationary forces where possible. In investment portfolios, one should try to use risk-adjusted asset allocations to make sure one is invested in assets that will 1) hold their value against inflationary pressures – these include precious metals, commodities, real estate, and industrial businesses that can pass on price increases, and 2) pay out dividends/distributions that can adjust upward as prices rise – thus, avoid fixed income for yield purposes, instead looking to REITs, MLPs, utilities, etc. One might still own Treasuries for safety and slight yield purposes, but owning fixed payment investments, especially if they have credit risk that could suffer in poor business conditions, should be avoided.

These three issues, all impacting our economic, financial and personal financial situations, are being minimized and dealt with as if they don't matter. Negative rates obviously really matter, but US financial authorities are staying with the "it can't happen here" mantra. Repo problems are still being called temporary while the Fed throws hundreds of billions of dollars at the "non problem." And ignoring inflation while pursuing initiatives that could lead to building inflation seems like the next big problem no one "could have seen coming" even though it is in plain sight. Stay tuned.

The Managers of Kanos Capital Management
© 2019 by Kanos Capital Management, LLC All rights reserved.