KANOS
CAPITAL MANAGEMENT, LLC

First Quarter 2021 Investor Letter

Portfolio Comments

The first quarter was characterized by the stimulus plans of the new Biden Administration and the ramp up in stock market activity and speculation, probably best epitomized by Bitcoin's tripling to $60,000. The roll out of US vaccinations and the anticipated increase in economic activity drove investors and speculators alike into stock markets worldwide, led by US markets. The Fed's zero interest rate policy and unceasing quantitative easing (Fed buying $120 billion per month of Treasuries/mortgage bonds) added to the rocket fuel for speculators, with speculative investments like cryptocurrencies, collectibles (especially sports trading cards) and art.

Kanos portfolios started the year with a good January but a poor February hurt our portfolios as rampant speculative fervor drove speculative darlings like SPACs (special purpose acquisition companies*), tech IPOs and cryptos to new heights, hurting larger, lower beta large-cap companies and safe havens, which are the majority of our portfolios. In addition, rising bond yields put pressure on safe haven investments like gold. A rebound in March brought portfolios back up from their late February/early March bottoms. Kanos winners were our energy stocks, industrials, defense stocks, commodity ETFs and the Bitcoin Trust. Losers were our precious metals, healthcare and materials stocks.

Looking forward, our portfolios continue to be positioned for the boom of the recovering economy and the inflationary pressures that are already manifesting themselves in prices all over the economy. In addition, the "correction" in large-cap stocks looks to have wrapped up during the first quarter, so our industrials, tech, materials, healthcare and commodity-oriented investments are already having a good April.

Market Analysis - Looking Forward

As we talk about below, the economy is starting to roar from the depths of the Covid recession, and this economic activity, coupled with the progression of fiscal stimuli from the US Government and the continued easy money "train" from the Federal Reserve, is pushing money into the financial markets at a near record pace, in spite of high valuations. We are near fully invested and expect these favorable conditions to continue into the summer but are leery of the "hangover" that could occur when red-hot growth reverts to more usual 1-2% growth seen pre-Covid.

** SPACs are "blank check" companies in which a sponsor IPOs the stock and then merges with an established private company. This is touted as a "more efficient" way for companies to go public, but there is an inordinate amount of "trust me" (and room for fraud/bad judgement) in the SPAC process and arena.*

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

Economy

The US economy has now hit the "sweet spot," with many large businesses conducting operations at near full capacity, absent most travel and entertainment businesses. Most small businesses that survived the Covid recession are now back in operation, either "blowing and going" or gearing up to get back to "full speed." US Government statistics show 4th quarter 2020 GDP grew 4.3%, and 1st quarter 2021 GDP is predicted by the Atlanta Fed's real-time GDP calculator to be up 8.3%: private forecasters have a more sane 5.2% estimate but that is in comparison to +/- 2% GDP per quarter for the last few years, post-financial crisis. These statistics are obviously generated against the equally huge drops in GDP last year when the Covid crisis forced federal and state governments to shut down much of the economy to quell the outbreak.

These GDP numbers are very large for a mature economy like the US economy, but the numbers are real, since they reflect the bounce back from a severe slowdown. The big uncertainties now in the financial markets are: First, stock markets worldwide have been climbing almost non-stop since April 2020, so is this fantastic economic bounce back already reflected in prices? Second, is this fantastic bout of growth only temporarily above growth, reverting to the pre-Covid slow growth economy and deflationary pressures? Or third, have economies formed new growth engines, pushing economies to better growth, resulting in higher prices for goods and services and higher interest rates? While these questions are impossible to answer at the moment, we believe that the result is going to be a hybrid answer: growth will revert to a more sustainable 2-ish% for the US economy going forward, but the lack of capital investments over the post-GFC (Great Financial Crisis of 2008-09) coupled with a Covid-complicated world and rising geopolitical tensions will drive up prices, rates and risk premia over time, helping materials, industrials, construction and services firms in the economy more than the tech, communications and information services firms that have thrived during the past decade.

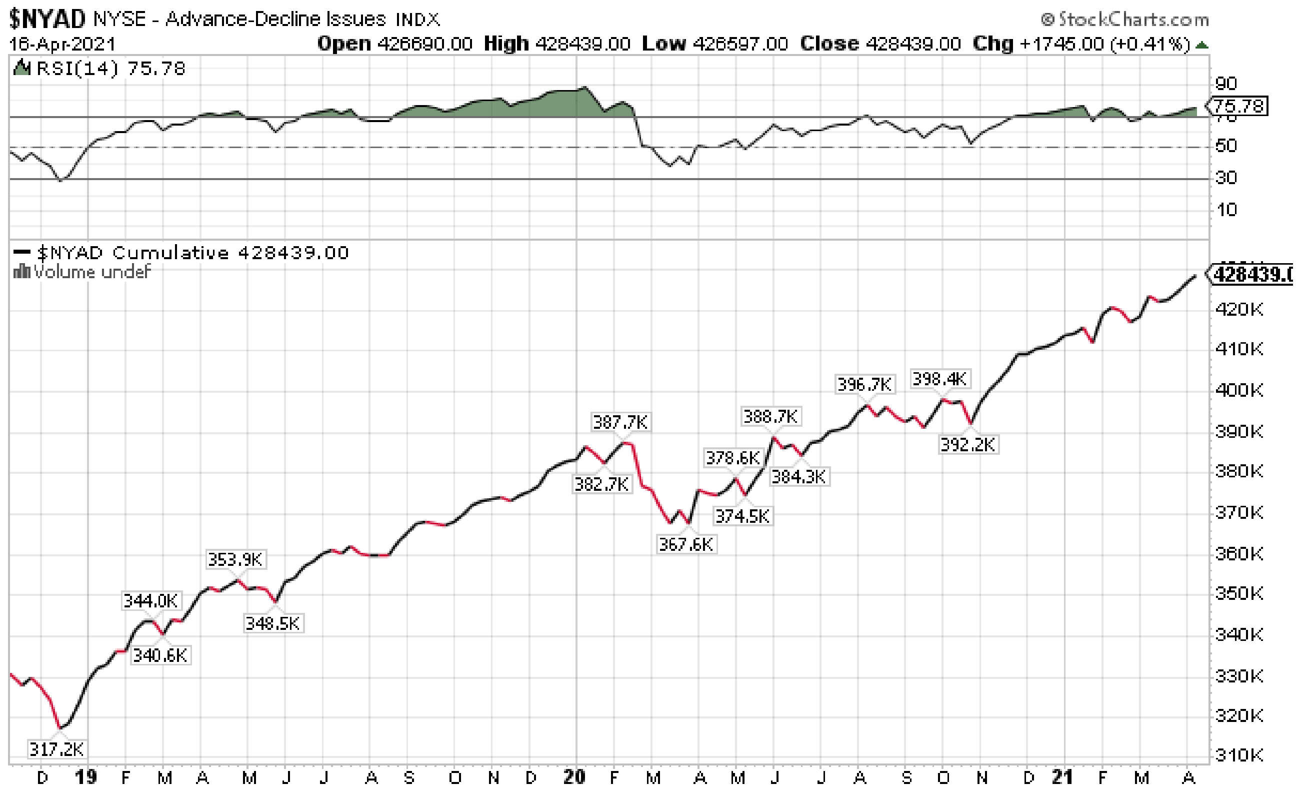
Equities

As mentioned above, equities are attracting lots of capital, as economic activity ramps up around the world (with stronger gear-ups in Asia and the United States), as widespread vaccinations and the change of seasons push people to more normal life patterns, especially economic patterns. Government stimulus has been plentiful and ongoing, whether through outright stimulus payments or unemployment payments (which currently still support almost 18 million Americans).

The reopenings in some US states last fall and the continued loosening of conditions throughout the rest of the US (and world) has led to optimism, and the fiscal "stimmy" payments has put money into people's pockets. The result? In the last five months (from November 2020 to March 2021), more money has been invested in stock funds than in the prior twelve years combined (since the GFC), according to Bank of America. This shows that optimism, greed and available funds are floating around in the economy.

Capital is available: so, how are conditions in the market? In February, large-cap tech stocks and SPACs reached an interim high which then led to a 5% correction in many of them. Cyclicals (materials and industrials, mostly) and other economically sensitive stocks took over "leadership" in the market, continuing to push indices to new highs, as did many small-cap stocks and small-cap indices. This rotation relieved some of the speculative "pressures" that had powered the market earlier. Thus, rotation among different industry groups as leaders during market advances has restored vigor to the market and having broad participation in market up moves shows the breadth of economic growth, something that has been missing from the markets for years.

Another positive sign is the technical picture. Technically, the market looks to continue its moves: broad participation is confirmed by the new highs in the New York Stock Exchange A-D Line, which is the cumulative count on how many stocks are advancing (the "A") less how many are declining (the "D"). The count goes up when more stocks are advancing, and the A-D count is currently at an all-time high, showing a large amount of stocks are continuing to rise (see chart below):



In addition, all three major indices are hitting new highs, and the small-cap Russell 2000 is not far off its highs. Momentum is taking stock markets up, and we are taking advantage of that in a risk-adjusted way, holding plenty of risk in addition to our safer assets that can still benefit from this environment.

What keeps us vigilant is: how much of the current economic upswing is already captured in the stock market moves? And when world economies cool down from their rapid reopening growth, do stock markets adjust strongly or not? No one has any way of knowing since no one has ever encountered this

rapid recovery with both fiscal and monetary stimulus on any scale approaching what we have in the US. But there is a non-insignificant chance that the inevitable inflation caused by overstimulation causes investors to protect themselves when growth settles down to more sustainable levels. We will know soon: the US economy (and many world economies) started to accelerate out of the Covid slump in the third quarter. Thus, as summer wanes, markets will be up against much more "growthy" comparables (both economic statistics and corporate results) from 2020; we may be able to see markets adjust (or not) in mid-summer.

Lastly, although the markets' moves higher reflect renewed economic vigor out of the Covid slump, there is a lot of anecdotal evidence pointing toward the possibility of an approaching top: these are examples of people buying things where most people shake their head, thinking of the timeless line, "… a fool and his money are soon parted …":

1) Early Facebook investor and former Facebook executive Chamath Palihapitiya floated one of the first SPACs of this 2020s SPAC era, which eventually merged with Sir Richard Branson's company Virgin Galactic, which is supposed to be taking tourists up into space (ticker: SPCE). It once reached a $16+ billion valuation, about the same market cap as Boston Properties (the largest US commercial property REIT with 196 Class A properties in major US cities) or Swiss Life (the large Swiss insurance company). SPCE is currently worth $5+ billion while still developing the hybrid airplane/rocket that will take super-rich tourists high enough for them to "see space" and feel briefly weightless. Palihapitiya has since floated five more SPACs, all of which are currently down at least 30+% from their highs;

2) Someone paid $69.3 million for the rights to a digital image of art by a semi-famous artist named Beeple, and someone else paid nearly $800,000 for the rights to a piece of art painted by an AI-powered computer. These rights, called NFTs or "non-fungible tokens," are a kind of "digital deed" that allows someone to own a tweet, or a film clip, or an image of a piece of art. This is another "greater fool" concept for "investors" who have made more money than they know what to do with;

3) Tiziana Life Sciences PLC, a $256 million market cap UK cancer biotech development company currently trading at $2.50/share, traded up as high as $12/share last year because its ticker here in the US is TLSA. Yes, very similar but not the same as a slightly more famous company with the ticker, TSLA, Elon Musk's Tesla. "Investors" don't buy the wrong company during bear markets; and

4) Dogecoin, the fifth most valuable cryptocurrency, is currently worth more than $50 BILLION, although there is no limit on the amount that will be minable, and it has no significant uses (it is used to tip online artists). And according to the article, "What is Dogecoin? How a joke became hotter than bitcoin," cnn.com, 4/17/2021: "Dogecoin was created December 6, 2013, by a pair of software engineers as a joke. Billy Markus, an IBM programmer from Portland, Oregon, set to differentiate his crypto from bitcoin, which was steeped in mystery with an anonymous creator and at the time attracted a small, niche group of miners. Markus wanted his cryptocurrency to be open to the masses. Markus looked for help making his weird dream a reality and found Jackson Palmer, who worked for Adobe. Palmer purchased the domain dogecoin.com — a nod to the "doge" meme that was all over the internet at the time." Now people have bought enough dogecoins for the total value to be worth $50 billion, more than Ford Motor Company, Kraft Heinz, Canadian Pacific Railway or Kimberly-Clark, etc. You get the idea.

Bonds

Bonds had their worst sell-off in many years during the first quarter, as US Treasury 10-year yields almost doubled during the quarter, moving from 0.93 at the end of 2020 to a high close of 1.749% on March 31. Long-term Treasuries were the worst performing asset class during the quarter, with the iShares 20+ yr Treasury ETF (TLT) losing 14.13% – worse than the Turkish lira (which dropped only 10.26% even though the Turkish central bank president was fired by President Erdogan for raising rates)!

Bonds are reacting to the double whammy of 1) higher economic activity, which typically causes more demand for loans, thus driving up their price (interest rates), and 2) higher inflation expectations, which is caused when lots of new money/bank reserves are created by the Fed or the government gives out money ("stimmy checks") and there is more money chasing the same amount of goods and services, causing higher prices. Prices of fixed income instruments like bonds go down during higher inflation periods, causing the real return on the bond to drop.

Unfortunately for bonds, 1) the Fed has promised to continue to stimulate the economy with near 0% short-term interest rates and monthly purchases of $120 billion in Treasuries/mortgage-backed securities until at least 2023 or at least such time as employment is restored to pre-Covid levels. So, monetary stimulus is expected to last at least through the end of 2022, if not through the end of 2023; 2) the Biden Administration, fresh off getting the $1.9 trillion Covid Recovery stimulus bill passed in mid-March, is actively campaigning for the early summer passage of a $2.2 trillion Infrastructure bill, which is expected to be followed by one more $2 trillion recovery stimulus bill. This amount of fiscal stimulus will affect the economy months after the final bill is passed, meaning all the way into mid-to-late 2022; and 3) fiscal stimulus is being paid for completely with Treasury debt, so trillions more dollars of Treasuries will be offered through auctions over at least the next couple of years, adding to the huge supply already outstanding – when supply outweighs demand, the price must go down (and bond yields go up). So, all three reasons should continue to put pressure on Treasury yields, forcing bond yields higher and bond prices lower.

For these reasons, we have little interest in bonds, except for keeping the relatively small amount of municipal bonds some people hold for income, diversification and their tax efficiency. We don't anticipate even considering buying any bonds until there is a change in the abovementioned dynamics – which almost certainly will be the Fed stepping up to buy more bonds, which would still discourage us from holding bonds, due to the rising dangers of increasing inflation.

Currencies

We wrote last quarter: "The singular event in the currency space in the last few months has been the ongoing weakness in the US dollar." The Dollar Index proceeded to bottom during the first week of January at 89.4 and rose during the first quarter to 93.41 at quarter end, when bonds reached their highest yield. Since March 31, the Dollar Index has bounced off its 200-day moving average and headed back down, pushed by the same forces affecting the dollar: more dollars created by the Fed, the

price of money (interest rates) held at artificially low levels, and fiscal stimulus authorizing massive new spending by government.

The problem, of course, with currencies is that each governmental authority does not want a strong currency, which will cause export prices to be less competitive worldwide. The eurozone has seen the euro strengthen recently as the dollar has dropped. The ECB continues to try to be stimulative and announced increased quantitative easing bond buying during the first quarter. But during April, Fed chatter and ongoing Biden Administration's fight for a large infrastructure spending bill has kept pressure on the dollar.

The Chinese yuan has strengthened relatively during 2021. The Chinese government has pursued less credit being made available and the PBOC (China's central bank) has even drained some liquidity during some recently weekly refundings, both of which have made the Chinese currency more valuable. Why would the Chinese allow the yuan to become more valuable? One reason is a stronger currency buys more imports! China has never recovered from their African Swine Flu outbreak which killed at least half of their pig population, robbing the country of its largest source of protein. China now has to buy large amounts of grains (for food and for feeding livestock) and proteins (soybeans and meats) to provide protein to their population – thus, sacrificing some exports (due to higher prices) in order to buy more food which makes some sense (hat tip to Russell Clark of Russell Clark Investment Management [russellclarkim.com] for some of this reasoning).

In Japan, the yen has been the mirror image of the dollar in 2021, falling during the first quarter as the dollar rose, and rising during April so far. The Japanese don't want a higher yen – thus, they are likely to have the Bank of Japan increase monetary stimulus further.

With all that said, we are not likely to invest in any currencies, not trusting the dollar to hold its value but remembering how foreign central banks continue to find ways to devalue. We will continue to look toward non-currency investments to hedge our risk of a depreciating dollar, things like gold and bitcoin.

Cryptocurrencies have become more widespread and our customers own at least a small amount of bitcoin, in a form tradable on the stock exchange through a trust vehicle known as the Grayscale Bitcoin Trust with the ticker GBTC. This trust sells shares of GBTC and uses the proceeds to buy "physical" bitcoins, so it is a way to participate in the rise of the original and most valuable cryptocurrency without having to worry about the custody or security of the bitcoin themselves. The two issues around GBTC are: 1) whether GBTC mirrors the actual value of bitcoin itself; it generally does not actually mirror bitcoin on a tick-by-tick basis. Historically, it has traded at a steep premium and other times at a steep discount to the underlying value of the bitcoin held (it now trades at a discount); and 2) it charges an annual 2% fee. We think the value of holding bitcoin through the GBTC is worth the fee (at least currently), and we have bought the majority of our GBTC at a discount to its underlying value, so (for now), we believe that GBTC, and its sister product ETHE (which holds Ethereum, the second largest cryptocurrency) are useful products for speculating in cryptos. We will look in the future to possibly increasing our holdings if cryptos break out to clear new highs (they generally trade in tandem with each other), but we could trim positions if they cannot make new highs and fall in value instead. Note:

Cryptos are part of the very speculative part of the portfolio and will only constitute a large position in the context of the riskiest part of any portfolio.

Energy

In direct contrast to bonds, energy investments (including crude, gasoline and energy stocks) were some of the best performers in the asset universe during the first quarter of 2021 with gains of 20-40% for various flavors of energy (Lean hogs, driven by extreme Chinese demand, were the best performer, up 44% for the quarter).

In the past few quarters, crude and product prices were vulnerable to further drops, making investments in energy shares risky in our eyes for that reason. On the other hand, a number of energy stocks, including the supermajors, seemed to us to be trading at discounts to energy prices, making them attractive investments in spite of the risk of further drops in price. The recovery from the March-April 2020 lows in energy prices and usage allowed us to add some more to portfolios.

Now, the dynamics have changed somewhat. Energy stocks, what most mainstream investment managers consider the opposite of the now popular ESG style of investing, have been divested by the majority of ESG investors. [Note: ESG investing is passing your portfolio through filters that gauge the amount of Environmental, Social and corporate Governance scores given to companies.] While worthwhile in sentiment, ESG criteria are not standardized, nor are ratings, and much of the ESG world uses political leanings and corporate reasoning to "qualify" ESG status of individual companies. Therefore, ESG has been "bent" to make portfolios "compliant" with very little rigor. We generally note ESG status and standards of the companies we invest in, but rarely do they impact our investment decisions. Thus, with former mainstream portfolios no longer holding energy stocks except for their bare minimums, most of the overhang of selling in energy stocks is probably done, meaning these stocks are also probably held by "stronger hands," managers who have actively sought out and bought the stocks, or index funds which cannot sell the stocks unless their weighting drops (and would have to buy more if their weightings increase).

In addition, in spite of the media blitz of green power and the "green new deal" and other green initiatives, the recovery from Covid is going to be powered mostly by petroleum products, and the low prices of the recent past, the increasing regulation, bans by the Biden Administration and the more difficult transportation of products (bottlenecks, two wars on the Arabian peninsula – Saudi Arabia-Houthis and the Syrian "civil war" – which affect oil supplies and transportation and Covid protocols slowing down world trade in general) are pressure toward higher petroleum prices that aren't going away.

With their diversified operations – exploration & production, refining and marketing, petrochemicals and other products (asphalt for roads/infrastructure, ethanol, etc.), energy companies, and supermajors in particular, look to be attractive investments, as we return to nearly the same economic levels as pre-Covid. That means petroleum/petroleum products usage 10-15% higher than current levels. We will be looking to add to our investment exposure to energy when attractive opportunities present themselves.

Commodities/Precious Metals

Commodities have continued to rally, even in the first quarter with a stronger dollar. The following chart shows the Invesco DB Commodity Index Tracking Fund (ticker: DBC) which is a general fund holding many different kinds of commodities (but with a major holding in energy):

The dollar rose through most of the first quarter but so did this commodity index, although it was virtually flat in March after both a rise and a fall. This is more fuel on the fire that commodities are a very good reflection, and thus, investment to express our view of rising inflation in the face of rising economic growth and supply deficits and logistical difficulties.

We continue to like agricultural investments due to: 1) continued export buying by China and other nations that have suffered food chain problems (China due to pork disease, other countries, particularly African, have seen Covid transportation problems), 2) drought in the US and some South American regions that is limiting supplies, and 3) the return a more of normal economy which will boost fuel usage, thus boosting corn and other grains for ethanol production, further boosting grain demand. We will look for attractive opportunities in either the grain ETFs or agricultural equities.

We continue to like base metals, although they corrected off their February highs. In particular, the push toward electric vehicles (EVs) will require large new supplies of copper (for EVs themselves, for charging stations and for electrical transmission infrastructure), nickel (especially for batteries) and tin (a

very good conductor). Silver is also an industrial metal which is used in a number of different green technologies including solar panels. We continue to like base/industrial metals miners and the commodity ETFs for investment here.

Gold, in particular, and precious metals and mining stocks suffered during the first quarter as investors looked to more risky investments and judged gold's attractiveness falling as Treasury rates rose. This is mostly due to inflation being judged constant, so lower nominal rates were thought to equate to lower real interest rates (nominal interest rates adjusted by inflation). In addition, a rising dollar is thought to make gold less attractive. The fall in gold prices from late summer highs has attracted more international buying. And in fact, China has ordered its banks to import more gold at these lower prices as the Finance Ministry introduces its own internal "digital yuan," touting that it is partially gold-backed.

However, as we have seen in April, gold and precious metals are world-traded assets, and the effects of the dollar and US interest rates can have short-term effects that don't affect prices in the future. High amounts of monetary stimulus (more dollars and yen and euros, etc.) should continue to make metals more attractive. US fiscal stimulus puts spendable dollars in consumers' hands, driving up prices of essentials and non-essentials as people spend, and in some cases, overbuy to hoard. And finally, government borrowing increases the vulnerability to high debt levels, pointing to the attractiveness of gold as an alternative store of value over dollars.

Summary

The economic recovery from Covid, world central banks continued easy money policies and the new Administration's fiscal initiatives point toward a continuation of the bull market in stocks. Stronger economic growth and budding inflationary pressures have forced up interest rates, causing bonds to have one of their worst quarters in 40 years and making them unattractive for Kanos portfolios. Energy, precious metals and other commodities have added to their recent gains while still nowhere close to levels seen in the 2005-2012 period, making them still attractive for further investment. World currencies are gyrating as governments continue to try to stimulate their economies and generate growth out of the Covid recession. The US continues to lead the world out of the recession, but we may have to adjust to different conditions as international opportunities could prove more attractive than the US in the latter half of 2021.

Pre-Commentary

Archegos Debacle – What Does It Mean?

We felt it was important to have a discussion about the "blow-up" of the "family office" Archegos, run by a shadowy financier named Bill Hwang. You may not have heard that much about it because there seems to be a lot that is unknown, or at least un-reported upon. But Archegos' buying did results in the following charts of two of their largest holdings, ViacomCBS and GSX Techedu:

ViacomCBS is the US entertainment giant which had lagged during Covid before Archegos buying:

GSX Techedu Inc. is a Chinese educational services stock that has been worth more than $20 billion at the highs. As you can see in the chart below, the stock has varied between $40/sh and $140/sh to $45/sh to $150/sh and back down to $33/sh (as of this writing, it has dropped to $24/sh).

Bill Hwang was formerly a famous trader for one of the largest and oldest hedge funds in US finance, Julian Robertson's Tiger Management. He then rolled out on his own to manage his own fund (as did so many Tiger portfolio managers that the new funds were dubbed 'Tiger Cubs'). The South Korean-born Hwang's fund was called Tiger Asia Management, and although successful, it was marred by his 2012 settlement with the SEC for insider trading (after which he paid a $44 million fine) and was also barred from trading for 4 years in Hong Kong, one of the major Asian financial trading centers. He ended up forming a "family office," essentially a hedge fund structure but without any independent customers, naming it Archegos, a Greek word meaning "leader" "pilot" "guide" "trailblazer" used in the New Testament a few times to refer to Jesus, an acknowledgement to Hwang's devout Christian faith.

In spite of his faith, he appears to have run Archegos in an extremely risky and at least somewhat deceptive way: he took his initial capital, thought to be around $500 million (the source of such a large sum is subject to lots of speculation and doubt), established accounts at more than eight "prime brokers" (full-service brokerage and lending services for hedge funds provided by large banks worldwide), and pledged either some or all of his capital to each of the prime brokers (without the others apparently knowing), thus raising his initial capital eight-fold! Instead of buying stock positions with his capital, he bought "total return swaps" from each of his prime brokers, a derivative that mimics the stock gains/losses + dividends of the underlying stock but requires just a fraction of the capital needed to actually buy the stock – let's say 10%, although it may have required less capital for Archegos to post (possibly as low as 5%). Thus, with $500 million, a reputation as a Tiger Cub and all the brokers willing to ignore his insider trading past, Hwang was able to take his $500 million, multiplying it with 8 prime brokers and 10 times leverage (needing to post just 10% allows you to buy 10 times as much) equaling **possibly as much as $40 billion of stock (or more)!**

His buying, especially in a number of US media and Chinese stocks, including the aforementioned ViacomCBS and GSX, but also Discovery and a number of other stocks, pushed up these stocks quickly and strongly. As the above VIAC chart shows, Viacom had barely participated in the post-Covid crash stock rise, staying in the $20s and $30s while many other US stocks soared after March 2020. However, starting in late 2020 and strongly in 2021, VIAC moved up from the high $30s to $100/share in less than three months, with Discovery making a similar move. Hwang made billions and billions on his positions, and the banks made lots of money on their brokerage, lending and market-making fees from him.

However, Chinese authorities, alarmed by soaring stock prices and "white-hot" speculation, announced that they were uncomfortable with "worldwide financial speculation" and stopped expanding credit, slowing the rise in Chinese stocks (or causing them to fall slightly, like GSX from its late January highs. It appears the turning point happened when Viacom, having seen their stock triple in a couple of months, announced a big secondary offering of stock when the stock was $100. VIAC fell to $91 that day, then $70 the next day when the offering priced. Allegedly Hwang was buying all the way up, even at $100, so when the stock started moving down strongly, each of the prime brokers started getting nervous about Hwang's reversal of fortune. It now seems that Morgan Stanley and Goldman Sachs sold a number of his holdings first, getting the best prices, and then as prices plummeted in a number of his holdings due to large sales by those two and other prime brokers, the stocks went into free fall. We only now know the prime brokers met before this debacle, but we don't know what was decided. We also now know the brokers who were last to realize that Goldman and Morgan were selling, namely Credit Suisse and Nomura, were left holding lots of now less valuable blocks of illiquid stock, causing them to lose $5+ billion and $2+ billion, respectively (since they had bought stock for Hwang's total return swaps with a weighted cost above prevailing costs and having lent most of the cost). Hwang and Archegos have been wiped out as his leveraged "scale up" buying on leverage caused losses in excess of his capital at most if not all of his prime brokers.

So – why are we relating this story? There are a number of questions still outstanding and also some implications or at least some possibilities to consider. First, the questions:

1) How was Bill Hwang able to use his capital to get credit at a large number of the largest, most sophisticated banks in the world without the rest of them knowing?
2) How did these large, well-regulated and well-run brokerage firms extend so much credit to one customer and then lose so much money when this customer's large, concentrated positions moved against them?
3) Isn't "copycatting" the most utilized strategy on Wall Street? How many more Archegos situations are there? Aren't the biggest hedge funds given the best treatment – possibly meaning even better credit terms than Archegos got?
4) Who called the meeting of the prime brokers and why did the debacle of selling the positions deteriorate more for some brokers than others?
5) Did regulators know about the Total Return Swaps (technically "Contract For Difference" swaps) extended to this and almost certainly to other "family offices" and are these "customer-less hedge funds" properly identified so these exposures by the banks properly monitored by their own risk management staff as well as by regulators?
6) These swaps effectively (across all the banks) gave Archegos a position of ownership far over the threshold of reporting a significant stake, but since Archegos didn't own the stock (the bank owned part of the swap and "let the rest ride"), no one could see that Hwang may have owned 20+% (effectively) of ViacomCBS and/or Discovery. How is the situation handled for investors (especially family offices) and how are regulators supposed to know about this large "economic concentration" or quasi-ownership?
7) Bill Hwang had a big charity with hundreds of millions of dollars in it – was it involved in these speculative investments, and if so, how was the charity monitored regulatorily?

Now, the implications or at least some possibilities to consider:

1) Federal and New York state securities regulators will almost certainly investigate the conduct and oversight of "family offices" and other less regulated investment entities.
2) New rules will probably be implemented for big banks, making their regulatory requirements and risk management systems more expensive and limiting their operations, making them less profitable and leading to less liquidity and trading for Wall Street
3) This sort of behavior is so profitable for banks that it will probably continue, possibly expanding in offshore venues instead of in New York if more restrictions are put in place to try to forestall this type of situation, and
4) There will almost certainly be another or a few more blowups that are bigger and force the Fed and/or regulators to run the unwind (think Long-Term Capital Management in 1998) that could threaten a large-scale downtrend in financial markets if it involves even larger entities and involves more widely held stocks.

This debacle is sooo predictable – easy money, plus rich, successful (and risk seeking) fund manager buying expensive swaps from a bank (making everyone at the bank big bonuses and "raising their market share" with other important fund managers). Mix in some volatility and any of a number of triggers – in this case ViacomCBS, seeing their stock quadruple in a few months, deciding to sell a big slug of stock and knocking down their stock price – and the whole thing comes apart. Also, it still looms out there that if a Bill Hwang could accomplish this, how many other larger entities have followed this

same strategy and are at risk, and putting the markets at risk? So far, we haven't seen obvious evidence of one, but we also haven't seen a large downturn in lots of stock lately either……

Kanos Quarterly Commentary

Wait, Didn't That Cost Less Last Week?

Following on last quarter's discussion of inflationary elements starting to appear, this quarter we are going to discuss three reasons we think inflation will be a bigger thing than most people think: inflation expectations, increased friction and food inflation.

Inflation Expectations

The Fed continues to deliver its message in the past few years that inflation is below their 2% target and that inflation expectations have been in danger of staying too low, which is bad because if people think prices are not going up – or actually might go down (deflation), they could defer purchases, causing the economy to grow slower (or even shrink in a recession). Thus, the Fed's message has been that "we have to maintain inflation expectations at a higher enough level so that deflation cannot take hold" or similar words to that effect.

Studying past bouts of inflation, especially the inflation that occurred in the US in the late 1960s and 1970s, we believe the main cause of sustained inflation was people's belief that inflation was here and would continue for an indeterminate amount of time. Fearing deflation, the Fed is trying to foster this thought because they think the lack of demand caused by the Covid recession (and already having occurred in 2018-2020 due to the petering out of the long 2009-2020 recovery from the GFC) could lead to deflation. They believe that lack of demand for products and services will lead businesses to lower prices to gain market share and stay in business. While a logical argument, it only considers part of the equation: there are two types of inflation, cost-push and demand-pull inflation. The Fed is only considering the demand-pull variety; if you boost demand, the increased demand will increase pressure to the point where businesses boost prices. But if demand falls, businesses must lower prices to keep business or to try to build market share. The analysis revolves around sales – the demand for products and services determines the price. However, cost-push inflation is different; it essentially says as supplies/materials/labor and other costs rise, businesses must raise prices to maintain their profitability. Thus, higher costs of labor and materials, typically from shortages due to some upset could raise prices, either temporarily or for longer. The Fed has dismissed these cost-push supply dynamics as temporary, or in their words "transitory," believing costs to businesses will revert to prior cost regimes, meaning demand will determine pricing as seen in the past few years.

We think that the Fed (and US Government) has done maybe too good a job of trying to change inflation expectations by 1) creating and sticking to the message that short-term interest rates will stay at zero for the next 2-3 year and that "we are not even thinking about thinking about raising interest rates"

(quote by Fed Chairman Jerome Powell at the April 2020 post-Fed Meeting press conference) and 2) by creating $120 billion of reserves per month until the economy re-attains full employment. The US Government has done its part by passing out "free money" in the form of "stimmy checks" now three times in the span of 11 months, with the implicit promise of more to come with the political conversations about Modern Monetary Theory (unlimited governmental borrowing) and Universal Basic Income (healthy citizens receiving government checks each month) continuing in spite of a budding strong recovery from the Covid recession.

Now it looks as though those inflation expectations are starting to take hold. A survey conducted in March 2021 by CivicSource interviewing 2,600 Americans had 77% of them "worried [either somewhat or very] about inflation." The disruption of supply chains, coupled with Covid restrictions on trade and Covid-induced industry shutdowns or slowdowns, have pushed up prices for products and services across the board for virtually all humans in all countries. The Fed thinks these will be transitory and that prices will revert back.

However, we are about to start getting inflation statistics that are going to look horrendous. The "base effect," where the comparison number from the prior year (in this case, 2020 during Covid shutdowns) will be very low, making the reversion to present prices look like a very large percentage gain. The largest example will be energy/gasoline: crude oil prices were briefly negative and prices in March/April were in the $20s/bbl. Now WTI crude is approximately $60/bbl, so crude inflation for April could print 200%! If gasoline went down to $1.00/gal and is now approaching $3.00/gal, that could print nearly a 200% increase year-over-year. The Fed considers food and energy too volatile to be considered for policy making, but for forming public opinions of inflation expectations, these base effect numbers could be very large and certainly could affect public opinion about inflation.

Finally, some prices are going up, higher than in recent memory, due to shortages that may or may not be solved soon. The big one is LABOR: the government's extension of very generous unemployment benefits has convinced millions to stay at home through the summer and collect unemployment instead of working, causing labor shortages and forcing businesses to raise the wages offered in order to get qualified workers. The US Government's ban on Huawei and other Chinese tech firms from buying semiconductors instituted last year led to these companies buying literally all the chips they could find before the ban was actually instituted, effectively scrubbing the world of semiconductor supplies that is now being felt across many worldwide industries, most notably automobile production, which has had to be limited across the world due to semiconductor shortages. Finally, the ramping up of plans for expanded green energy will take larger and larger amounts of base metals copper, tin, aluminum, nickel and rare earth metals; the lack of recent investment in mines for these materials (due to low prices and expanded environmental investment precepts) means that supplies are too limited for any rapid expansion, and current supplies are being bid up in price. Below are the recent price curves for copper and tin (as displayed by the tin exchange traded JJT), both of which are far higher than their pre-Covid prices:

$COPPER Copper - Continuous Contract (EOD) CME ©StockCharts.com
16-Apr-2021 Open 4.05 High 4.24 Low 3.99 Close 4.17 Volume 43.5M Chg +0.13 (+3.17%)

JJT iPath Series B Bloomberg Tin Subindex Total Return ETN AMEX ©StockCharts.com
16-Apr-2021 Open 71.42 High 74.32 Low 71.28 Close 74.32 Volume 1,742 Chg +1.92 (+2.65%)

We think inflation expectations are being anchored in consumers' and business people's minds more and more, and that the Fed's efforts to keep inflation as the expectation of choice are working.

Increased Friction

In the mid-1990s, just after China and emerging East Asian countries (Malaysia, Thailand, Vietnam, etc.) started really exporting to the rest of the world and the breakup of the Soviet Union led to even more cheap labor and manufacturing / raw materials capacity available to the world, the World Trade Organization was formally instituted to facilitate world trade. Trade among member countries (who had all ratified the Uruguay Round of trade terms in 1994) was made simpler and cheaper for the developed

nations of the world, European Union members and others with more open economies for trade, including India. The cutting of red tape, tariffs and other trade encumbrances led to freer trade, and free trade, coupled with the emergence of commercial adoption of the internet, led to lower prices and broader access to goods and services around the world.

Since the early 2000s, things have been moving "the other way." First, the 9/11 attacks happened, ushering in the War on Terror. But more importantly, it introduced new layers of security into travel, shipping, banking, etc. Suddenly, travel took longer because of security checks; shipping took longer because cargoes had to be checked for security and law enforcement reasons; banking and finance had to have paperwork and checking of sources of funds, knowing your customers, etc. These "frictions" caused prices to go up as the cost of security had to be included and covered.

Covid brought a number of restrictions, too: transmission fear meant that world trade was either slower, delayed or cancelled in some cases. Covid ravaged workers at both production and shipping facilities, causing limitations on supplies and lengthened shipping timeframes. Shortages of products and services have led to higher prices due to the "friction" of Covid conditions that may or may not revert to pre-Covid prices and conditions right away.

Then this happened last month:

The bad weather that caused the massive Evergreen container ship "Ever Given" to swerve and get stuck, completely blocking the Suez Canal for nearly a week, is not atypical. In fact, there is very little that is atypical about the elements of the incident except possibly the larger and larger sizes of the ships

going through Suez. The containership can hold four times as many containers as the typical ship held just twenty years ago.

The pictured accident is another incidence of "friction" in the delivery of goods that impacts prices currently (and could last much longer). The blockage caused more than 400 ships to delay their transit and possibly 50+ ships to divert around the Cape of Good Hope (South Africa) to add an extra 60% in time and costs (mostly fuel) to deliver the current cargoes.

Of course, the uncertainty has led to shipping lines pulling their extra capacity to take care of previously-booked cargoes due to the slowdown of any ships stuck at Suez. In addition, shippers will charge more to take into account the possibility of having to circumnavigate Africa. And perishable cargoes will have precedence, thus causing even longer delays for other goods.

But it doesn't stop at that: almost certainly, all large ships are going to be required to use tugs in the Suez Canal, meaning more time (tugs are not currently required, so more tugs will be needed if their use is mandatory). And their usage will add to costs, including the increased time to get through the canal by having to wait for a contracted tug to arrive. The security of making sure a ship isn't used to block the canal on purpose will have to be instituted. All of these are new costs that will have to be added to costs of products. More friction everywhere.

This latest "Incident at Suez" could also be a possible danger at other choke points for shipping around the world, especially at canals (obviously in Panama but also locks and river transportation in northern Europe, St. Lawrence/the Great Lakes in North America and in coastal Asia, especially in the Straits of Malacca off Sumatra. Shipping has been getting more efficient with containerization and the advent of very large ships like Evergreen's "Ever Given". However, the progress of efficiencies looks to be slowing by frictions being added to our transportation systems, most recently highlighted at Suez.

Food Inflation

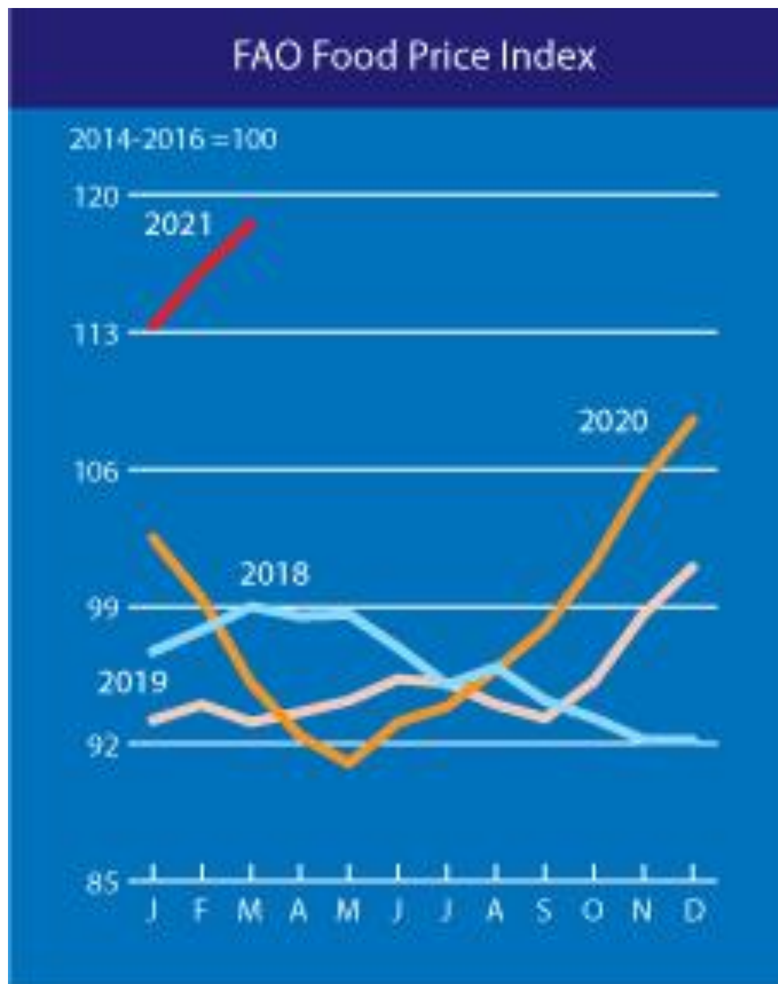
Food inflation has been largely absent from the world scene for many years due to the entrance and enhanced productivity of farming in formerly Communist Eastern European and Asian countries and milder weather which led to better growing conditions worldwide.

However, more recently droughts, coupled with widespread livestock diseases and geopolitical conflicts and trade degradation, have meant more strained food chains and higher food costs as supplies have not kept up with demand.

Russell Clark Investment Management in London has done a lot of research lately on food costs and budding Chinese food inflation, showing that Chinese "appetite" for foreign foodstuffs has pushed up prices, first in China and increasingly, worldwide. Their data shows Chinese pork, the largest source of protein for the Chinese people, saw prices doubling over the past two years. Why? African Swine Fever decimated pork herds first in Africa and spread to Asia, affecting Chinese pigs in 2019 and requiring culling of more than half of all live hogs in 2020, pushing up prices in China and worldwide. In addition, pork producers worldwide hit by swine fever have had to try to rebuild their pig populations,

requiring even larger supplies of grain stocks for feed, leading to strained grain supplies and budding shortages.

The Food and Agricultural Organization of the United Nations (FAO) measures food supplies and prices worldwide, and their FAO Food Price Index (FFPI), which tracks monthly changes in international prices of baskets of food commodities, rose for the tenth straight month in March 2021, 2.1% higher than February. According to their website, fao.org, "…[t]he increase marked the tenth consecutive monthly rise in the value of the FFPI to its highest level since June 2014. The increase was led by strong gains in vegetable oils, meat and dairy sub-indices, while those of cereals and sugar subsided." The following graph from the FAO that shows prices rising in late 2019 (pink line), dipping in 2020 (orange line) but then rising strongly for the rest of 2020 and through 2021 (red line).



Economic blogger Michael Snyder in his April 13, 2021 article Food Prices are Rising Aggressively … points out recent US food inflation statistics quoted in an NBC News article titled Get Ready for Higher Grocery Bills for the Rest of the Year: "… the national average for a pound of bacon in January 2020 was $4.72. By last month, the price had soared to $5.11, according to exclusive supermarket point of

sale data from NielsenIQ. Ground beef is up to $5.26 a pound, from $5.02. Bread is up to $2.66 a loaf, from $2.44. The hikes are more acute in certain areas. Boston and Philadelphia are paying nearly a dollar more per pound of bacon, while in Chicago it is up by about 70 cents. Several items spiked by over 5 percent at once in Dallas, including eggs, chicken breast, fresh ground beef and sandwich bread." The US Labor Department reported in mid-April 2021 that the Consumer Price Index rose 0.6% in March 2021 (over February 2021 prices) and 2.6% year-over-year, showing how food inflation and other inflationary forces are starting to show up in price increases across the board.

To make matters worse, the United States' western regions are currently in a severe drought, as shown in the following map from Drought Monitor (www.droughtmonitor.unl.edu):

The orange, red and black regions are showing severe (or worse) drought conditions, meaning crops are failing and water supplies are inadequate for normal agricultural production. Half the US is showing extreme conditions currently (from Texas, Kansas, Nebraska and the Dakotas and westward), meaning US crop yields will be lower than the recent strong harvests in 2019 and before, putting pressure on agricultural prices, especially since a large amount of US fruits and vegetables come from California, which is completely consumed by the drought to various extents.

Russell Clark's research also points to a link between food inflation and wage inflation; as food prices rise, workers demand higher wages to pay for life's essentials, starting with food. And higher food prices hits the Earth's poorest hardest, because they pay a large percentage of their wages for food. Thus,

higher food costs lead to more stress in poorer nations, and higher prices also lead to unrest and inadequate supplies. Michael Snyder's blog article on food also references an article from The Christian Post (christianpost.com) titled Over 7 Million in East Africa on brink of starvation... by Emily Wood (April 11, 2021) in which evangelical humanitarian organization World Vision warns "violence, flooding, the pandemic and locust infestation" in Ethiopia and other East African countries has led to the lowest food supplies in years. Higher worldwide prices for food don't allow countries to import food to replace crops destroyed by drought, flood and conflict.

In summary, the conflagration of disease in pork herds, droughts in East Africa, the western United States and other places, the shuttering of trade for the pandemic and inflationary forces from fiscal and monetary stimulus efforts worldwide have resulted in higher food prices in 2020 and 2021. While central banks see food inflation as a "transitory" problem that is almost always "solved" by higher harvest years after droughts, the combination of events leading to severe food price spikes could continue for months or years, cementing inflationary expectations for food in people's minds, which in the past has perpetuated behaviors that led to continued price pressures for longer times than economists estimated.

The Managers of Kanos Capital Management
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