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Second Quarter 2022 Investor Letter

Portfolio Comments

The markets in the second quarter were brutal, with large drawdowns in virtually every market as higher interest rates combined with fears of imminent recession convinced investors to sell assets, although some defensive sectors survived better than the overall market averages. The war in Ukraine, high inflation and weakening economic activity contributed to the downturn in markets. China's outbreaks of Covid and their severe lockdowns contributed to worldwide economic weakness. The supply chain problems from the last few months have started to sort themselves out, and many commodities experienced corrections during the quarter, but economies around the world still seem to be slowing down. The travel/leisure and entertainment sectors seem to be the strongest as postponed travel occurs worldwide. For the first half of 2022, the US Government 10-year bond performed the worst since 1788, the year before George Washington was inaugurated as our first President (according to Deutsche Bank), and the US stock market performed the worst since 1970.

Kanos portfolios had a bumpy quarter as the inflation and commodities positions had corrections in the second half of the quarter. Our quarter was characterized by a steady April, a weaker May and a very weak June, in most portfolios. Leaders to the upside were very few, with pharmas, specifically Merck (+12.0%) and Johnson & Johnson (+0.8%), and some energy stocks, like Exxon (+4.6%) gaining. Most positions had declines this quarter, especially many of the leaders in the first quarter: precious metals miners including Newmont Mining (-24.3%) and Agnico Eagle Mines (-24.8%); technology stocks including Microsoft (-16.5%) and Alphabet/Google (-21.7%); and commodity stocks like CF Industries (-16.6%) and the Rare Earth/Strategic Metals ETF (-26.6%). Some smaller, more speculative stocks were less weak, like Crispr (-3.1%). Fixed income investments were weak again, although muni bonds were steady.

In the markets, assets experienced losses across the board: the S&P 500 lost -16.10% during the second quarter, ending at 3,785.38, while the Dow Jones Industrial Average fell -10.78%, ending at 30,775.43, and the Nasdaq Composite fell -22.44% (all performances reflect total returns). There were no quarterly sector winners; the best performers were: Consumer Staples (-4.04%), Utilities (-5.09%), Energy (-5.26%) and Healthcare (-5.91%). Quarterly laggards included Consumer Discretionary (-25.51%), Communications (-20.88%), Technology (-19.67%) and Financials (-17.50) [all performance amounts reflect total returns]. The US dollar was the only real safe haven, with the WSJ Dollar Index gaining a large +6.82% for the quarter. Despite dollar strength, US bonds had another awful performance, with iShares 20+yr. Treasury ETF losing -13.03% for the quarter; the 10-year US Treasury bond dropped at quarter-end to 2.973%. Most commodities corrected during the quarter, with only a few commodities gaining: Nymex RBOB gasoline (+14.43%), US diesel (+5.61%) and Nymex WTI crude (+5.46%) were joined by Cattle (+11.35%). Lean Hogs (+7.25%) and Soybeans (+3.51%). Commodities correcting included: corn (-0.67%), gold (-7.44%), wheat (-13.64%) and silver (-21.68%). Cryptocurrencies were drubbed, with Bitcoin losing -59% for the quarter during which number of crypto firms were found to be insolvent and went bankrupt.

Introduction

The first half of 2022 has given us the transition from Covid recovery to recession watch, with inflation continuing to impact consumers and economies, while central banks try to walk the tightrope of tightening monetary policy without choking off growth.

In the second half, many indications are that policy makers will be less aggressive with interest rate increases, which will benefit the stock and bond markets and lower the chance of recession. This is because many believe inflation may be peaking, allowing central bankers to moderate their tightening program. We look at market conditions to determine what may lie ahead, as many economic statistics indicate a slowdown in progress, but corporate earnings, job gains and consumer spending show that economic weakness may only be occurring in certain sectors.

Economy

In the US, prices remain high for seemingly all goods and services, but consumers have continued to spend at near recent activity levels in spite of higher prices. This pattern has led to uneven results in economic and earnings announcements, in which most spending has continued, including consumer staples, travel and entertainment and energy products, while consumers appear to have dropped their spending activity in consumer discretionary items (which people splurged on during Covid lockdowns), consumer durables (although many, like cars, continue to be supply-constrained, limiting measurement of peak activity) and houses (due to affordability).

Meanwhile, the unemployment remains low at 3.6% as the labor market continues to be tight, allowing workers to continue spending but also keeping labor costs high. Some Covid workforce dropouts, combined with Baby Boomer retirements, have shrunk the pool of available highly skilled talent, keeping labor demand by companies strong. (This seems like a long-term issue for US and other developed economies – the shortage of skilled workers in a highly technical world. Wholesale retraining of lower or unskilled labor must occur to start to solve the issue, but so far, this does not seem to be a focus, as most government officials continue to believe US consumers are employed and have high savings, which seems to be less and less true, looking more deeply into recently released economic statistics).

Two recent economic reports show stress being put on US consumers: US consumer credit report and retail sales report. The last couple of months of consumer reports have shown large increases in revolving credit (credit card balances not paid off) and retail sales that have looked strong but have not exceeded the reported monthly rate of inflation. Both of these show weakness – the American public, reputedly with strong balance sheets due to Covid lockdown limitations and government largesse, is borrowing on their credit cards at historical levels, and while they are spending, that spending is only increasing due to higher prices; it is lower when adjusted for inflation's price changes. These reports show a stressed consumer not keeping up with recent spending, in spite of high employment. The following is a graph with both economic series displayed from the 7/21/2022 ZeroHedge article "The State of the US Consumer: AT&T Crashes As Americans Can't Afford To Pay Their Phone Bills." In the graph, the red line is personal savings as a percentage of disposable income (moving downward over

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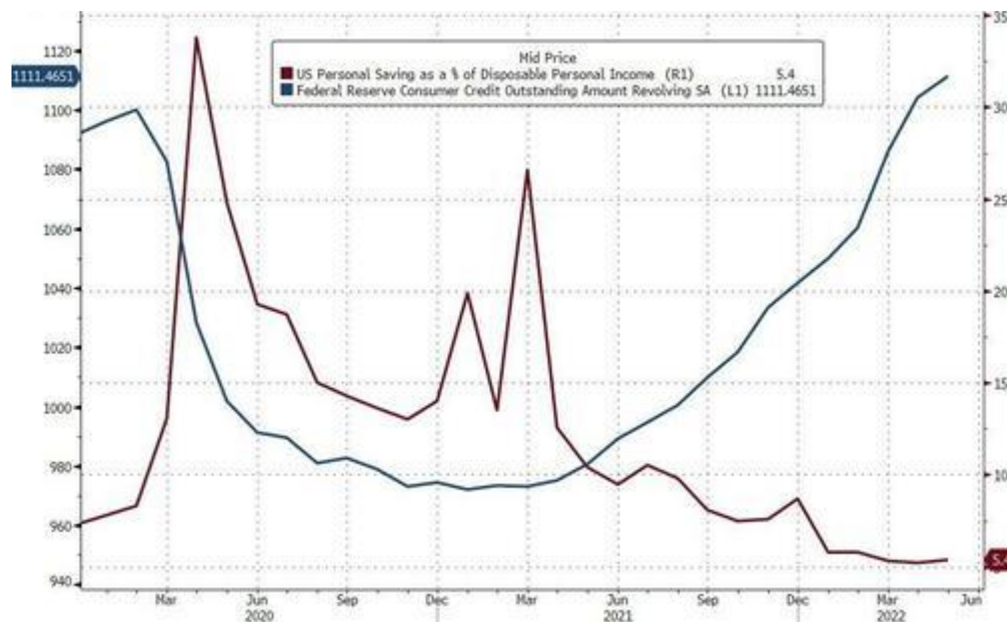
time), and the blue line is Federal Reserve data for Outstanding Revolving Credit (bottoming during Covid and moving upward quickly).



Other indicators are also concerning. The Leading Economic Indicators (LEIs) are followed by many economists as indicators of future economic activity. One prominent pattern is three consecutive months of lower LEIs often mark the approach of a recession. The LEIs have just been reported for June, and there have now been <u>four</u> consecutive months of falling LEIs, which also points to recessionary conditions approaching. Most economists, however, point to one main indicator to "guarantee" the approach of recessions: two quarters of negative GDP growth, and that, too, has just occurred: after a -1.7% growth deficit in the first quarter of 2022, the second quarter has just been released at -0.9% shrinkage of GDP, signaling that we are <u>in</u> a recession, by the GDP measure.

Traders often try to gauge the approach of the slowdown of economic conditions by looking for the inversion of the Treasury bond yield curve, specifically the difference between the 10-year Treasury bond and the 2-year Treasury note. When the 2-year yield exceeds the 10-year by at least fifteen basis points, a recession has followed within a few months afterwards. And it usually doesn't just "touch" the level, the inversion of interest rates lasts at least a few days or weeks, showing that market participants continue to see the 2-year Treasury yield above the 10-year Treasury's yield, which generally means capital is going into 10-year Treasuries (more money is driving up prices, which lowers yields) because people are parking money in government bonds for safety, not knowing whether a 2-year note has a long enough maturity to mark the end of the recession.

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As seen in the chart above, the 10yr-2yr yield differential has only been below -15 a few times in the past 30+ years, and since mid-July 2022, it has been around -22 bps, recently dropping to -30 bps. This is a warning that we will have recessionary conditions in the next few months. As you can see, it also reached these levels in 2000 and 2007, before two of the biggest recessions the US has had since the 1980s.

We are concerned that the US economy is slowing, with rising prices sapping purchasing power while food and energy take more money and show little evidence that they will be dropping in price anytime soon. Prices are expected to go down as economic conditions grow worse for many Americans, pushing down demand, with prices to follow. However, since many pricing pressures have been supply problems, prices may not ease downward until supply problems are solved, which could take longer than is commonly expected (usually just months into a recession).

One last point about the US: the Fed has been getting pressure from the Biden Administration to do something to help alleviate the inflation problem, which currently polls as the most important issue to Americans and will probably determine many midterm elections in November. The Fed has been obliging with very large interest rate hikes, which impact both inflation and the economy, especially when they are seventy-five basis points, which we've gotten the last two meetings. Now, as recessionary factors build, we are starting to hear Administration and government officials grousing that interest rates are climbing too fast and impacting the economy in many different locales. It will be interesting to see if Fed rhetoric changes as we approach the elections (and Administration pressure mounts); many think that rhetoric already did change at the last Fed meeting (in July) when Chair Powell said the FOMC will be "data dependent" on making monetary policy changes going forward. However, there is a large difference of opinion on whether that means more dovish monetary conditions are coming or not.

Europe is in worse shape than the US. Inflation is higher in both the UK and EU periphery than in the US, and economic growth was already anemic there. Obviously, the energy situation, exacerbated by the Russian war with Ukraine, is front and center, with fuel for industry and HVAC at the highest prices in history due to shortages of natural gas and difficulty getting oil and coal supplies. In fact, energy and other industrial inputs have become so expensive, that Germany recorded its first trade deficit since 1991. Now most of Europe is facing reduced natural gas flows from Russia, threatening that at least Germany may run out of natgas from storage during the winter. This has pushed up natgas prices in

Europe to over $50/MMBtu (in the US, natgas wholesales for about $8/MMBtu), which threatens the ability for Europeans to pay for heating/air conditioning (there is currently a heatwave in Europe) and European industry that counts on at least reasonably priced energy (chemicals, utilities, steel and other basic manufacturing that requires lots of heat, etc.) to compete with similar international products produced with lower energy prices.

Asia, while facing high worldwide energy prices, has managed to keep some economic growth. China, which chose extreme lockdowns to try to squelch its big Covid outbreak, has muddled along with very low growth as many industries were slowed or practically closed during the April-June lockdowns. Now, most of China is open (although some cities have returned to limited lockdowns) and industry has regained some strength, but only in the 2-4% annual growth range, probably half the rate of growth pre-Covid. While some have expected a reopening boom like happened in the West, China's economic statistics show only slow growth out of the lockdown-induced economic drop.

Japan, South Korea and the other East Asian countries seem to be growing slowly too, but since they are mostly exporters, slowdowns in the US and Europe almost certainly translate to slowdowns throughout East Asia too.

World economies seem to be falling slowly into recessionary conditions, as inflation bites. Central banks are geared up to fight inflation, but all are warily watching economic statistics to see if slowly rising interest rates will cause recession and economic woes before inflation is put down.

Bottom line: we expect the US economy to continue to decelerate as higher interest rates and less Fed liquidity combine with higher prices to constrict consumer and business spending. Stocks are vulnerable due to still relatively high earnings expectations and multiples. Europe is a basket case economically, and while Asia still shows growth, its export focus means it will suffer as US and Europe experience recession in the near future.

Equities

As the Fed fights inflation and is slated to raise interest rates at the rest of its 2022 meetings after raising rates seventy-five basis points at its latest (July) meeting, US stocks have continued to suffer as higher interest rates and higher costs due to inflation cut down on projected earnings in 2022/2023.

As of early August, stocks have recovered somewhat according to a narrative that inflation is peaking, and that after inflation has peaked, falling inflation will allow the Fed to pivot from hawkish inflation-fighting to dealing with a slowing economy, which market participants think means slowing the tightening cycle. In addition, the perceived onset of recession in the next few months has led the bond market to put more of a bid on longer-term Treasury rates, which makes stocks more attractive, causing some money to return to beat-up tech stocks. The market, which has been oversold after months of losses has responded as a number of large corporations beat expectations when reporting second quarter earnings and short sellers covered short positions, adding to the buying. However, many other stocks, most notably smaller tech stocks as well as Covid lockdown favorites have been beaten up further as their earnings fail to keep pace with lowered expectations.

Meanwhile, fears of demand destruction from the coming recession have hit industrial, materials stocks and energy stocks (beginning in April with China's lockdowns) and that weakness continues – fund and

pension managers have been cutting down on stock investments in cyclical companies as they fear recessionary cuts in demand more than inflation boosting sales and potential profits at these companies.

We examine the difference in outlook and valuation in a number of US stocks in the Kanos Commentary at the back of this Investor Letter, but the valuation discrepancy between growth and value stocks is still stark, especially in the case of many large cap stocks, and we believe that reduced earnings growth at a number of companies will continue to highlight their high valuations, which leaves them vulnerable to further declines in their stock prices in 2022.

We want to acknowledge that value stocks, led by energy, were large outperformers through the first 3 ½ months of 2022, but the onset of China's Covid lockdowns coupled with mounting realization that US and Europe were approaching recessions knocked down expectations and thus stock prices from late April through the present. Meanwhile, while we respect that recessionary conditions will lead to weakness of demand for cyclical companies' products, we still strongly believe supply issues will continue to favor many companies over others, meaning there are still bargains in the market where fears are overdone, and earnings will surprise to the upside. In numerous markets, including many energy and metals markets, inventories are low and price premiums for immediate delivery are still high, showing demand is still strong for many physical products in basic industries around the world.

Thus, we continue to hold investment positions in energy, metals, precious metals, pharma/biotech and other attractive large cap stocks. To be clear, we still believe that underinvestment in energy, metals and other basic industries are leading to supply problems, and the "digitized investment world" which got used to surpluses of materials after the 2000s commodities boom doesn't understand the time, capital and, most importantly, investment and environmental commitment to new supplies that is needed to ensure materials for all the infrastructure, new and old, that must be either built, expanded or at least maintained to make our civilization not only continue to run but to advance to more modern and efficient systems.

Foreign stocks have continued to be poor investments for US dollar investors as the strength in the dollar has led to higher commodity prices / even high inflation for the rest of the world, especially emerging markets who cannot afford it. Throw in the geopolitical turmoil, and they are even harder to invest in, except commodity producers.

Bottom line: we continue to like value stocks, led by commodity producers. Despite a large drawdown during the April-July period as a hawkish Fed combined with recession and demand fears which drove traders and investors to dump energy, metals producers, industrials and many other value stocks, we see a rebound in most of those stocks and continue to consider them attractive for the future. We continue to look at beat up shares in other sectors that we feel have potential upside when recessionary forces start to fade, so we plan to redeploy into a broad portfolio as we see recessionary forces resolve themselves.

Bonds

As we referenced earlier, according to Deutsche Bank, bonds have had their worst first half of the year since 1788 (the year before George Washington was inaugurated as the first President of the United States). The Fed holding rates at zero into 2022 while still buying billions of dollars of bonds monthly far after the Covid emergency has made their "about face" even more damaging to bond values as

interest rates screamed higher with high inflation raging, while then made worse by Russia's attack on Ukraine and the additional inflationary forces of limiting food and fuel out of Black Sea countries.

The growing belief that inflation is near peaking, however, has stopped the rise in interest rates, and thus, the drop in bond prices. Investors have been attracted by 3% rates for both 2-year Treasuries (good yield for safe places to park cash) and 10-year Treasuries (recession fears). The growing fear of recession has made some investors flock back to longer-term Treasuries, as they think that the safety of US Treasuries and longer duration offsets the diminution of value caused by high inflation. This is so ingrained, that after mid-July's release of the Consumer Price Index, the yield curve (in this case, the closely watched 2yr-10yr Treasury spread) went negative by 20+ basis points and has stayed at those levels through late July, further signaling the onset of recession.

Since we still believe that inflation, while moderating, is more structural due to supply constraints, we are not yet willing to increase our allocation to long-term bonds as an investment, although we have bought some for short-term positions in more trading-oriented accounts. We also believe that you should not "fight the Fed" in this case, since they are not only no longer buying Treasuries, but are letting their Treasury (and mortgage bond) investments run off, creating more supply and not standing to buy any, for the first time since fall of 2019. This dropping demand (by the former largest buyer), along with growing supply (the US government continuing to run trillion dollar per year budget deficits) and the erosion of purchasing power by still present inflation, continues argue that bonds are currently unattractive for further capital allocation, in our opinion.

International bonds seem even less attractive to us, as the US dollar strength makes inflation worse in other countries, since most commodities, most notably energy commodities, are traded in US dollars, so a rising dollar makes commodities even more expensive in local currency terms. Inflation in the UK and Europe is higher than in the US, making European bonds doubly unattractive, along with the geopolitical and short energy threats eroding the value of their bonds.

Asian bonds have held up better because inflation has been more muted in many of these countries, with energy providing most of the inflation shock. However, we see falling demand for exports, along with high food and other prices, combining with high energy prices to impact Asian economies and further diminish any attractiveness to holding their bonds. Most Asian central banks, while raising interest rates now, are behind the inflation fighting curve, meaning large, quick raising of interest rates could cause economic shocks and affect growth.

Bottom line: We may buy some bonds for short-term trades or for some safety for risk-averse clients, but we don't think bonds are attractive for large allocations of capital at this time. Inflation still high, governments continuing to run deficits, and central banks moving from being buyers to sellers of government bonds combine to make them poor risk-reward candidates now and into the future.

Currencies

The US dollar has been "king" during the quarter, as US monetary policy is considered more hawkish than other major central bank policy, drawing money to higher interest rates. Dollar strength has been the dominant FX force for the past few months, with unusual strength caused by 1) euro weakness due to ECB dovishness due to economic weakness in the EU, and 2) Japan's pegging of 10-year Japanese government bonds (JGBs) to the 0.25% level, causing the yen to weaken appreciably (as the Bank of Japan buys unlimited 10-year JGBs, creating more and more yen).

While foreign central banks like the Bank of England, the Swiss National Bank and Bank of Canada have all raised rates substantially (as have the Bank of Australia and New Zealand Bank, to a lesser extent), these banks are still considered "behind the curve" when compared to the Fed, and their currencies have kept up somewhat with the US Dollar's rise, to an extent.

The Bank of China has kept rates relatively low compared to rivals, which has kept the Chinese yuan at very low levels compared to its relative economic strength. This has made the yuan cheap compared to the dollar and other currencies, keeping Chinese goods more competitive and keeping monetary policy stimulative but risks capital flight as Chinese wealth is devalued. We don't think the Chinese will revalue the yuan since they want to keep some economic growth, and their lockdowns have helped squelch some of the inflationary pressures felt by the rest of the world.

Bottom line: We believe the US dollar is around closer to a peak, especially in light of investors' beliefs that Fed rate hikes may be slowing, but until we see a trending decline, we will stay on the sidelines as far as currencies go.

Energy

After far outperforming all other asset classes during the first third of the year, oil and oil products (gasoline, diesel, etc.) have undergone a rather substantial retrenchment as $100+ oil prices incentivized more production worldwide and Chinese lockdowns squelched demand, with China still not recovering to pre-Covid levels as intermittent Covid outbreaks continue to crimp some of China's energy demand.

However, having said that, most of the rest of the world has responded to months/years of being cooped up and are traveling extensively, while business is back up and running throughout most of the world.

At the same time, continuing pressure by environmental groups and "woke" governments have retarded further petroleum development, denying leases, failing to approve new energy projects, be they additional pipelines or hydrocarbon exploration. The US government is out front in this movement, bowing to environmentalists who want all fossil fuels removed from use as soon as possible, consequences be damned. These two groups are abetted by ESG (Environmental, Social, Governance) initiatives by some large organizations in the financial markets that both steer investments away from fossil fuel projects while some even ban further investment (even lending). Other groups have divested or are disinvesting from any current hydrocarbon-oriented investments.

With a background of oil products demand continuing to build worldwide but supply hindered by enemies of further development, we continue to think that oil investments are attractive and will continue to be as long as supply initiatives are not embraced by governments and businesses – which could take a long time, with current Western politicians in charge and many not changing their attitudes toward energy.

Meanwhile, Russia's strangling of Europe through limiting its supply of natural gas has kept prices at astronomical highs in Europe, as the Continent goes through a mid-summer heat wave while trying to store as much gas as possible for winter. The last few years' developments of LNG exports from the US have generally been targeted to Asia, so LNG won't be the answer for Europe for the 2022-2023 winter, although they are bidding away as much as possible from around the world to try to make sure Europe can scrape through. This bidding war has pulled up the price of LNG and US sourced natgas to highs

not seen in years, while the producers' stocks don't reflect this as an ongoing situation. Like oil investments, we think that US natgas producers will continue to make money selling natgas domestically, and LNG facilities being built or repaired will continue putting a floor under gas prices for months/years to come.

Finally, the other fossil fuel, coal, is making a comeback worldwide. Germany is recommissioning coal plants while China continues to open more new coal plants, since coal represents the marginal Btu for the world right now. Environmentalists plus the ESG movements have almost killed the coal production industry (in the US), but coal still represents approximately 22% of electric generation in America currently. Coal is in high demand worldwide and lack of investment over the past few years around the world means there is also a high demand for US coal exports. We continue to think that coal company stocks represent bargains that produce products in high demand at very low-cost structures (virtually all coal companies have gone through bankruptcy in the last ten years, with those that emerged operating at sustainable cost structures) and paying out dividends to investors, as well as showing capital appreciation.

Finally, investors as a whole are still woefully underinvested in energy. At the end of the quarter, energy stocks still represented only 4.4% of the S&P 500 (it was 10.9% in June 2014 last time crude was over $100/bbl). Many pools of capital in the US have ESG mandates that limit their investment in energy investments. Big capital allocators are said to eschew energy investments because of poor past returns and high volatility last time oil traded over $100/bbl. And funds have been flowing out of energy investments starting in 2Q of 2022, meaning many investors think that the coming peak in the inflation rate means that oil prices have peaked and will come down with the inflation rate.

We completely disagree with those betting that oil prices and demand have peaked. Normally, high prices would attract capital to the industry and into the stocks, providing money for more production projects; then, rising supply would combine with demand destruction due to high prices to end the boom. This is what has happened numerous times, most recently in 2002-2014. However, this time, supply is not being developed, due to governmental and environmental movements. In addition, disinvestment has been in effect during most of the 2010s, meaning worldwide supplies have probably used up most of any reserve margin (Opec+ is having trouble producing their quotas of production even now). With Covid almost completely shutting down any further development during 2020, supplies for world consumption are way behind development to merely maintain supplies, much less add more to drive down prices. "This time is different" actually does apply here because the move to renewables has been occurring too quickly, not leaving enough fossil fuel supplies needed for instant dispatchability, continued growth in transportation demand, more extreme summer and winter temperatures and geopolitical upset.

Bottom line: We continue to think that favorable supply / demand situations, both in the US and worldwide, point to the attractiveness of energy investments, including supermajors, independent producers (both those oriented to oil and/or natgas production), pipeline/midstream companies, refiners and coal companies. Even oil service stocks, generally only good buys at the very beginning of energy booms, look attractive now after being beat up in the stock market over the past two months.

Commodities

Commodity prices corrected from April to July as China went into Covid lockdown and stopped buying their usual quantities of almost everything. It sure looked like they cut their buying severely to apply

price pressure, since China as a whole is the largest buyer of most commodities. Metals, both base and precious, have suffered the worst, although agricultural commodities also dropped in price, especially when Russia, Turkey and Ukraine reached a deal to export Ukrainian grain in late July. As recessionary fears built around the world, these commodities dropped further – but we believe all of this weakness is merely timing: we still have large supply concerns caused by underinvestment (metals, energy) or poor growing conditions (agriculturals). The recoveries have already started in earnest as China and other buyers have re-entered markets and prices have recovered from mid-summer lows.

The agriculturals have suffered from the overhang of Ukrainian wheat and other ags that have been harvested but couldn't be exported. Now that there is a solution to that, wheat and corn corrected back to their pre-war prices, and prices are bottoming. Poor growing conditions (drought in China, American Southwest and some of South America) has led to reduced supplies, and ending supplies of these crops are projected to be lower than last year as the world pulls on inventories to make up for yearly supply deficits.

The base and precious metals, hurt by a higher US dollar, recessionary fears and delayed Chinese buying, fell from April to July, but prices have turned around as the US dollar finally is correcting and Chinese re-enter markets. Trend-following funds have shorted these commodities as prices weakened, but now they must start to cover these short positions, adding to buying pressure and higher prices.

Bottom line: with fundamentals unchanged, the US dollar correcting and buyers re-entering markets, we continue to stay with our commodity and commodity producers as investments. We see the drop in prices as current supplies start to adjust better to demand, but, like energy, these metals businesses have seen under-investment since the last bull market ended in 2012, meaning supplies are harder to find and more expensive to produce, putting even more pressure on prices. Current producers are now realizing good profits which allow them to reinvest some, but also return capital to investors just like in energy. Commodities will have to rise in price to attract new investment so that more production can supply the world in the future.

Summary

The US economy is either on its way into recession or is already in one. However, with a strong dollar and strong employment, US consumers continue to spend, but at a diminishing rate due to high inflation and uncertain futures. High prices continue to affect the rest of the world too, and the energy crisis facing Europe will come to a head in a few months when winter hits. Currently, with the export economies of Asia starting to slow and Europe slowing rapidly with high energy and product prices, the US is still more attractive for investments.

There are still many attractive stocks in the market despite the slowing economy. The sharp drop in stocks worldwide, led by formerly high growth, high valuation stocks, took some of the froth out of stock markets, but it is still up in the air how markets will function as the US slides further into a slowdown. The high US dollar has made international investments perform poorly and are mostly unattractive, especially with high energy prices and looming winter uncertainty over supplies. We continue to see energy and other commodity producers as low valuation, lower risk ways to be exposed to earnings growth while receiving good yields and feeling like we are preserving value. We continue to like pharmaceuticals and consumer staples; not only do they provide lower volatility earnings and price movements, but they pay relatively large dividends and are expanding business. We continue to like defense stocks, especially now that the Russia-Ukraine war has used up stockpiles which are in need of

replenishment. Planes, ships and other military equipment is actually in need of extensive repair and maintenance, so there are many attractive companies. We like industrials and some transportation companies because we see US national, state and local governments continuing to rebuild infrastructure, and we believe reshoring will attract more need for industrial materials and factory parts.

Bonds continue to be unattractive because of still-high inflation, still-high government deficits, and yes, an "unfriendly" Fed who is still raising interest rates and accelerating QT, which will put more bonds on the market.

A correction in the US dollar still does not present good investments in other currencies but does allow commodities to rebound from their spring/summer swoon, especially with China re-entering markets. We continue to be bullish base metals, precious metals and agriculturals due to the years-long under-investment.

We continue to look for growth at a reasonable price in the technology, communications and consumer discretionary sectors. While we have been able to find some bargains, high valuations continue to be the rule for high growth companies, so we have been picky when trying to buy growth companies, wanting to see how recessionary forces affect demand, stock prices and sentiment before moving more significant capital into higher valuation sectors.

Kanos Quarterly Commentary

Stock Valuations: Where Do We Stand?

With prices down for most financial assets during 2022, we thought it was a good time to look at current valuations of some of our holdings and other stocks in the market, to show you why we hold various types of assets and avoid others.

When we analyze a company, we examine financials, valuation parameters, growth and business drivers, management and location/business environment. We typically try to use analysis from a number of sources, and we use a number of valuation methodologies to try to look at a company's stock from various perspectives.

To be concise here, we will be using only a few variables we typically use, but they give a general flavor of current valuations, so it is a useful "short-hand." The parameters we will use this study include: 1) Market capitalization - to judge current valuation and the ability to grow, 2) Dividend yield - to see how capital is being returned to investors, 3) Earnings per share growth for both the a) past five years – to see how profitability has been growing, and b) next five years to see how earnings are expected to grow, 4) Price/Earnings Ratio for a) past four quarters – to gauge recent earnings and current broad valuation, and b) next four quarters – to see how investors/ analysts see earnings and thus determine price, and finally 5) Price/Sales Ratio – one of the more "pure" valuation parameters that is hard for managements to manipulate, so it gives a good snapshot on valuation. The data is provided by our charting and information service Financial Visualizations (finviz.com).

In addition, we are including a chart of each stock which is in a weekly format and includes two moving averages (1-year and 2-year exponential moving averages). These are the blue and red lines on the chart that show the average price using the last year of prices as data (blue line) and using the last two years of prices (red line). The chart gives us a roughly two-and-a-half-year view of price action of the stock, and the moving averages give a smoothed level of where prices have been in the recent past. The moving averages are often used by traders and investors to judge where stocks should eventually trade, since valuations are often considered to "revert to the mean" or trade back toward recent levels. The chart will also show recent highs and lows, to help judge how valuations apply and where each stock is in its recent range. All the charts come from our charting service Stockcharts.com.

We are going through this exercise to show that even after a big drawdown in the markets, the market hasn't changed that much. Popular large-capitalization stocks are still very highly valued, while the world seems heading into recession, while a number of cheap stocks that make money and pay generous dividends are considered very vulnerable and have far lower valuations.

We have devoted a page to each stock we are examining below, so turn the page to see the first study:

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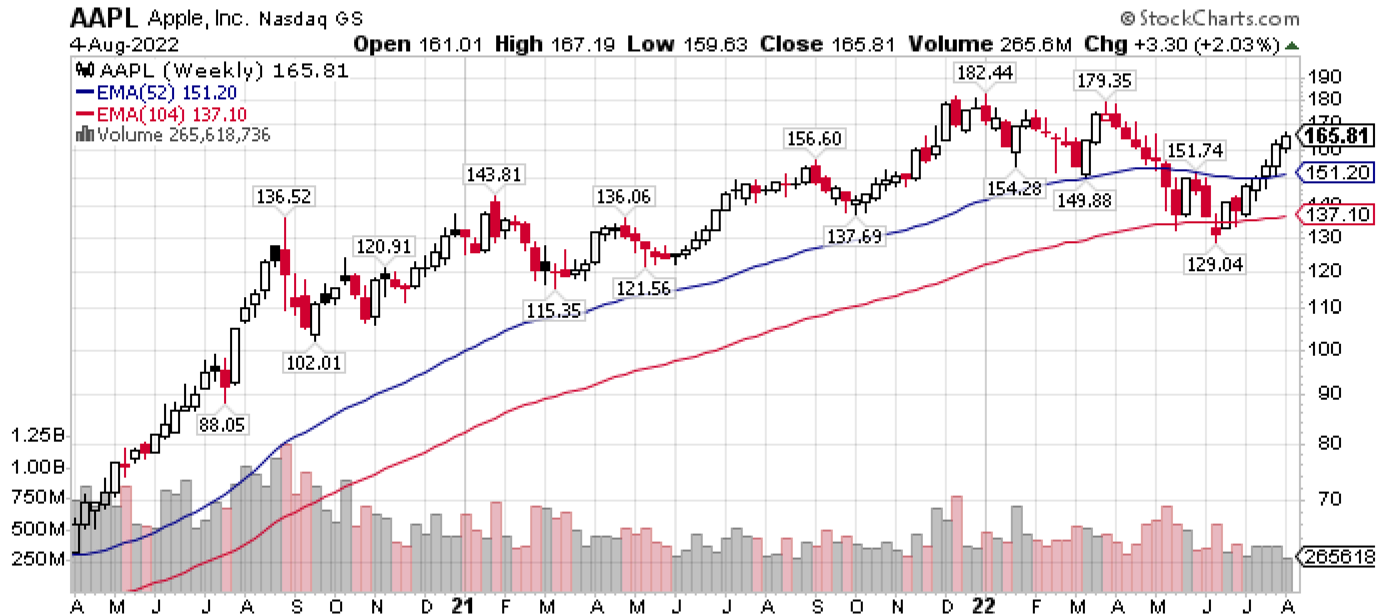
Apple Inc.



Market capitalization: **$2,594.20 billion**

Dividend yield: **0.55%**

Earnings per share growth (past five years): **22.00%**
Earnings per share growth (projected next five years): **9.83%**

Price/past earnings: **27.45x**
Price/ forward earnings: **25.70x**

Price/sales: **6.69x**

<u>Company Situation:</u>
Apple is the largest capitalization stock in the world. Since former CEO Steve Jobs passed away in 2011, the company has introduced only minor improvements in products (and the overdue introduction to the Apple Watch) – no new products or initiatives. Thus, Apple has become a cash cow company, growing in fits and starts when the next iteration is released, hopefully with a "nifty feature."

<u>Valuation:</u>
Next 5 years earnings growth is supposed to <u>average</u> less than 10% per year (a large deceleration), but the company sells for 26x forward earnings and almost 7x sales. It is hard to maintain big growth in a mature product, especially when they must grow sales of almost $400 billion each year. The stock market has judged Apple to have done everything right, but the company must deliver large swaths of growth just to maintain its current 'growthy' valuation. In a post-Covid, slowing economic growth world, the valuation will be difficult to maintain, especially with no new products and if the Fed keeps tightening. The company only pays a nominal dividend even though it makes and holds billions of dollars of cash. We don't own Apple anymore because we are concerned about its lack of growth and absence of real innovation while still sporting a high valuation.

KANOS
CAPITAL MANAGEMENT, LLC

Agnico-Eagle Mines Ltd.

Market capitalization: **$17.85 billion**

Dividend yield: **3.75%**

Earnings per share growth (past five years): **25.80%**
Earnings per share growth (projected next five years): **0.39%**

Price/past earnings: **24.01x**
Price/ forward earnings: **19.14x**

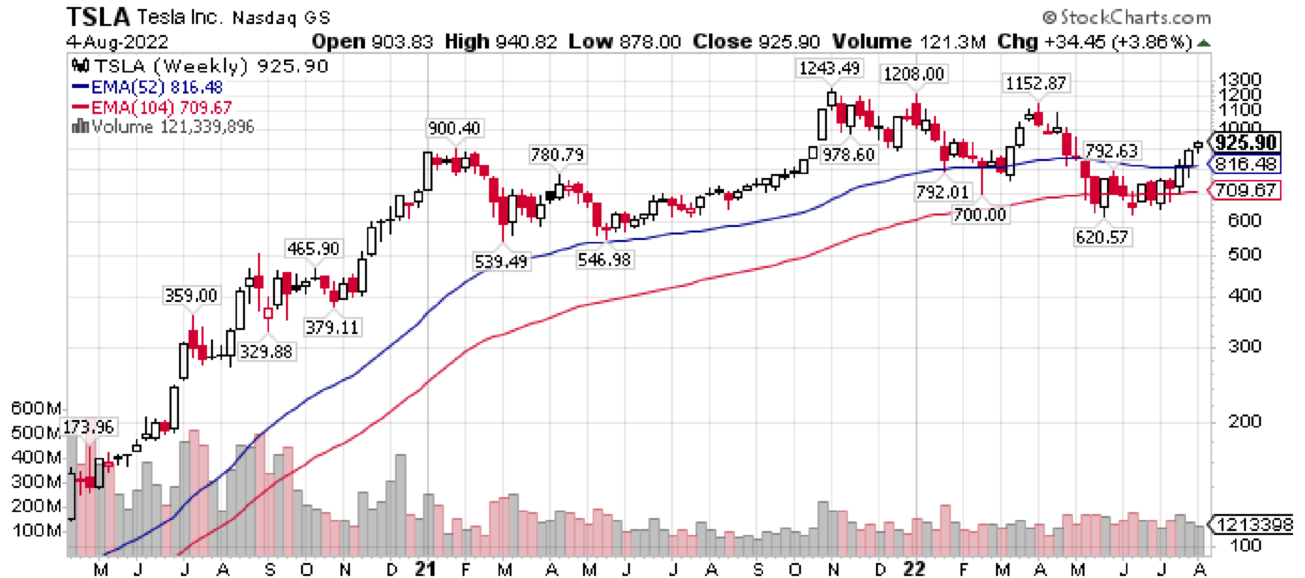
Price/sales: **3.70x**

Company Situation:
Agnico-Eagle is considered the best gold miner in North America (it trades at a premium to all the other miners), and it may be the best in the world. It has consistently built, operated and produced from mines for decades and currently has twelve operating mines in mining-friendly Canada, Australia, Mexico and Finland. It has numerous large growth projects, not only from its recent purchase of Kirkland Lake Gold (Detour Lake Mine) and TMAC Resources (Hope Bay Mine). The assertion (red rectangle around Next 5 Year EPS above) that there will be no earnings growth with these large (accretive) projects is almost certainly mistaken. The company pays an almost 4% dividend, so they expect to continue to make good profits going forward.

Valuation:
Since AEM has been an excellent operator in an uncertain business, it is usually priced at a higher valuation than other mining companies. In addition, mining companies in general have seen valuations slip due to higher presumed fuel costs, equipment costs, employment costs and supply chain issues; however, Agnico runs many underground mines that use less fuel than most miners, and the company has generally managed expenses extremely well. It also usually beat on revenues and earnings, under promising and over delivering – as it just did this week, as we go to press. AEM is one of our largest holdings, and we believe its valuation will be rebuilt as AEM continues to show its expertise.

KANOS
CAPITAL MANAGEMENT, LLC

Tesla Inc.



Market capitalization: **$926.12 billion**

Dividend yield: **none**

Earnings per share growth (past five years): **48.60%**
Earnings per share growth (projected next five years): **51.89%**

Price/past earnings: **110.69x**
Price/ forward earnings: **54.97x**

Price/sales: **13.79x**

Company Situation:
Everyone knows Tesla as the first major electric vehicle manufacturer, but the valuation says a lot more; valuing a car company at tech company multiples means that investors value Tesla's electronics and programming like a monopoly tech stock. The genius of Elon Musk also is a plus for the company.

Valuation:
Tesla's valuation only makes sense if you believe the company will maintain its nearly 80% market share of EVs in the US that it achieved in 2019. Its earnings are expected to grow at a higher rate in the next five years, at a greater than 50% rate, which is hard to do when they only make around 14-15% on each car. Meanwhile, investors are giving them a valuation that only the "growthiest" of tech stocks achieve – even though Tesla is limited in the number of cars it can build and complete, especially with recent chip shortages. We continue to think this is an insane valuation, especially when compared to other car manufacturers, like Ford. And the stock is down 33% from the highs! We don't own Tesla; if the valuation ever gets down to a level with which we feel comfortable, we will consider buying it.

KANOS
CAPITAL MANAGEMENT, LLC

Ford Motor Co.

Market capitalization: **$56.63 billion**

Dividend yield: **3.82%**

Earnings per share growth (past five years): **31.10%**
Earnings per share growth (projected next five years): **8.33%**

Price/past earnings: **5.46x**
Price/ forward earnings: **7.78x**

Price/sales: **0.38x**

Company Situation:
Ford is one of the US Big Three automakers and is dedicated to building a number of electric models. Its best-selling F-150 pickup will soon sport an EV model, and Ford continues to sell Mustangs and new Broncos successfully. The stock boomed during 2021, but it has been caught up in the 2022 selloff that engulfed anything to do with EVs. Ford also pays a 3.0% dividend, showing their cash flow generation and belief in a bright future.

Valuation:
As you can see above, Ford is ridiculously cheap when compared to Tesla, showing they are barely comparable in investors' eyes. Ford shows how it has been very successful, growing EPS in the past five years over 30% and has made enough to currently pay a 3.8% dividend. Investors don't think Ford can keep up the momentum or develop EVs that are anywhere comparable to Tesla, as shown by its single-digit P/E multiples both current and future, as well as its prospects (only projected to earn 8.33% EPS growth) even though the 280 million US car fleet is supposed to convert in the next few years. The price/sales ratio says it all – Ford sports a 0.38x P/S compared to Tesla's 13.79x – 36 times bigger. We believe one of these valuations is wrong, especially with a recession dead ahead. We don't own Ford but have been considering a position as we better gauge how the recession will affect the company.

KANOS
CAPITAL MANAGEMENT, LLC

Nvidia Corp.

Market capitalization: **$462.63 billion**

Dividend yield: **0.08%**

Earnings per share growth (past five years): **43.10%**
Earnings per share growth (projected next five years): **22.80%**

Price/past earnings: **50.69x**
Price/ forward earnings: **30.18x**

Price/sales: **15.66x**

Company Situation:

Nvidia is the darling chip stock of the last few years, growing from the video card chips purveyor in the 2000s to the "go-to" specialty chip maker (most notably for cryptocurrency miners) in the 2010s. It has expanded its portfolio of chips, and the company spends lots of money designing complex graphics chips that are then manufactured by sophisticated foundry companies like Taiwan Semi.

Valuation:

NVDA has always sported a high valuation due to its complex chips and reputation for high-speed chips. However, the rise in interest rates and approaching recession concerns have driven down the stock price almost 60% from its highs before getting a bounce midsummer. Even with the big drop, its valuation is very high: 15.7x sales and 50x this year's earnings are very high multiples, especially as the company is only supposed to grow its EPS 23% on average over the next five years. It only pays a "courtesy dividend" (so that funds that can only invest in dividend payers can own it), so it will have to continue to produce high-margin, best-selling graphics chips to reward investors. It seems hard to do, especially with recessionary fears getting stronger in markets. However, Nvidia continues to be an innovator, and if investors were to bring down their high expectations, we would look buying some NVDA stock in the future.

KANOS
CAPITAL MANAGEMENT, LLC

Ericsson Telephone Co.

Market capitalization:	**$24.93 billion**
Dividend yield:	**4.18%**
Earnings per share growth (past five years):	**92.90%**
Earnings per share growth (projected next five years):	**5.11%**
Price/past earnings:	**11.01x**
Price/ forward earnings:	**10.18x**
Price/sales:	**1.04x**

Company Situation:

Ericsson is the Sweden-based communications equipment supplier that operates primarily in North America, Europe and Latin America. It also provides services and software to its hardware systems forming complete communications, networking and cloud systems for telecom operators and businesses all over the world.

Valuation:

Ericsson has evolved with technology to provide all sorts of communications, networking and cloud solutions mostly in North America and Europe, but it is not considered a cutting-edge company, and the valuation shows that. In spite of its growing EPS an average over 90% for the last five years, growth is expected to be anemic (only averaging 5% for the next five years) even though it pays a 4.18% dividend. A 10-11x P/E, both current and forward, shows the lack of investor enthusiasm, and an earnings miss in early 2022 (didn't hit expectations) plus European business prospects during a war have cut the stock price nearly in half. We don't own Ericsson but have been researching it as a possible new holding – it may prove to be an earnings oasis in a bad European recession in the next couple of years.

KANOS
CAPITAL MANAGEMENT, LLC

Shopify Inc.

Market capitalization: **$53.58 billion**

Dividend yield: **none**

Earnings per share growth (past five years): **124.00%**
Earnings per share growth (projected next five years): **n/a**

Price/past earnings: **315.54x**
Price/ forward earnings: **822.16x**

Price/sales: **10.71x**

Company Situation:
Shopify has been the darling retailer-oriented tech stock for a number of years. The company provides end-to-end solutions for managing small and medium retail business, handling inventory, sales and accounting for companies worldwide. They expanded as e-commerce boomed during Covid lockdowns worldwide, gaining market share and reputation. However, recent company earnings reports show they have over expanded and are currently having layoffs as they “right-size” the company.

Valuation:
Shopify could do no wrong in the market for the past few years. It hit an all-time high at 176 in November 2021 (split-adjusted), but the tech bust caused by higher interest rates and now recessionary concerns has hit the stock very hard, falling more than 80% from the 2021 highs before bouncing back slightly. However, it is still no bargain: selling for 11x sales, 315x current earnings and still sporting a $54 billion market cap. Future EPS growth estimates are all over the map (one estimate is for -68% average per year for the next five years), so this valuation still seems to be quite high. We are attracted to Shopify’s business model, but the valuation is still far too high to invest in the company, especially with growth uncertain.

KANOS
CAPITAL MANAGEMENT, LLC

Chevron Inc.

Market capitalization: **$278.19 billion**

Dividend yield: **3.66%**

Earnings per share growth (past five years): **100.80%**
Earnings per share growth (projected next five years): **24.14%**

Price/past earnings: **14.61x**
Price/ forward earnings: **9.82x**

Price/sales: **1.57x**

Company Situation:
Chevron is one of two US energy supermajors, with oil and gas production around the world, along with refinery, chemical, marketing and distribution business around the globe. The company is a large concentration in the US, and Chevron is extremely well managed.

Valuation:
Chevron is the higher valuation of the two US supermajors, due to its good management, growth prospects and mix of businesses. The recent explosion in earnings due to Covid reopening and increased by Russia's attack on Ukraine shows the earnings power of this large company. The expected average 24% EPS growth for the next five years is extremely high, but CVX still only trades at 15x this year's earnings and less than 10x next year's earnings, while paying out 3.7% per year in dividends. Kanos customers own quite a bit of Chevron, which is almost unmatched for growth prospects with an attractive valuation and high relative dividend.

KANOS
CAPITAL MANAGEMENT, LLC

CrowdStrike Holdings, Inc.

Market capitalization: **$43.69 billion**

Dividend yield: **none**

Earnings per share growth (past five years): **-13.40%**
Earnings per share growth (projected next five years): **+72.89%**

Price/past earnings: **none (no money made)**
Price/ forward earnings: **109.98x**

Price/sales: **26.70x**

Company Situation:
CrowdStrike is one of the hedge funds' / investment managers' "go-to" cybersecurity stocks since it is well-known and has grown very quickly. Sovereign and corporate warfare now encompass cyber operations, and CrowdStrike is known as a competent ally for defense and cyber autopsies when compromises occur.

Valuation:
Despite CrowdStrike's rapid growth and reputation, the company has never made money (it has only been public since early 2019). The company has grown to $44 billion in market cap on revenues of only $2 billion in sales but is expected to transform into a profitable company this year, even factoring in an economic slowdown. Analysts think the company will make a profit in 2022 then double its EPS in 2023 and subsequent years. A price/sales ratio of 27x and forward P/E of 110x are very high for a company whose sales are growing 50% yearly at best. We don't own CRWD and would have to see a much lower valuation and proof of profitable operations before consider owning a position.

KANOS
CAPITAL MANAGEMENT, LLC

Gerdau S.A.

Market capitalization:	**$7.06 billion**
Dividend yield:	**11.50%**
Earnings per share growth (past five years):	**49.10%**
Earnings per share growth (projected next five years):	**5.33%**
Price/past earnings:	**2.57x**
Price/ forward earnings:	**1.09x**
Price/sales:	**0.44x**

Company Situation:

Gerdau is a Brazilian-based multinational steel producer with operations in Brazil, North America and Latin America. It blends raw materials into finished and semi-finished products for a number of industries in the Western Hemisphere, including construction, manufacturing, industrial and energy companies. It also has a large recycling operation.

Valuation:

Gerdau is a large company that operates in ten countries and employs 30,000 people. Yet, with Brazilian roots and in an old-style industrial business, steel making, it only sports a $7 billion market cap. The miniscule P/E ratios, 3x this year's earnings and just over 1x next year's expected earnings, shows investors' doubt about Gerdau's and other steel makers' prospects, especially with recessionary winds blowing. And investors may be right, as GGB paid a blockbuster 11.5% dividend in 2021 which is almost 2x what it made during the year, obviously unsustainable. However, the company's track record shows that it grew EPS nearly 50% on average over the last five years, so the current 5% average EPS growth expected for the next five years seems pretty low. We don't own Gerdau, mostly because the strong dollar has hurt emerging market operations and their stock prices, as well as the building recessionary forces worldwide. However, Gerdau has proven to be a worthy worldwide competitor, so we will diligently look for an attractive entry point as we see how the recession shapes up.

KANOS
CAPITAL MANAGEMENT, LLC

The Coca-Cola Co.

Market capitalization: **$270.37 billion**

Dividend yield: **2.76%**

Earnings per share growth (past five years): **8.50%**
Earnings per share growth (projected next five years): **5.50%**

Price/past earnings: **28.94x**
Price/ forward earnings: **24.40x**

Price/sales: **6.54x**

Company Situation:
Coke is a worldwide drinks provider with a superstar brand but a slow-growth business. Coca-Cola has been tackling this slow growth over the years by adding other types of drinks, especially water.

Valuation:
Coke has gotten a premium valuation due to its strong brand and steady profit generation, but as we consider it compared to other companies in this survey, it appears expensive on a valuation basis. Investors value each dollar of sales at $6.54 of market cap (a high 6.54x price/sales) but earnings have only grown at an 8.5% rate for the last five years and are supposed to decelerate to 5.50% for the next five, not exactly a big growth indicator. In addition, the cost of one of Coke's big inputs, corn, has risen due to worldwide droughts and Russia's attack on Ukraine, which may further constrain profits. Earnings steadiness is also valued by investors, giving a 29x current P/E ratio and a 24x forward P/E, seemingly high for such slow growth in EPS. Kanos has sold its legacy KO holdings because of this overvaluation, but we would consider reinvesting in a lower valuation regime.

KANOS
CAPITAL MANAGEMENT, LLC

BHP Group Ltd.

Market capitalization:	**$130.89 billion**	
Dividend yield:	**3.14%**	
Earnings per share growth (past five years):		**92.90%**
Earnings per share growth (projected next five years):		**-9.91%**
Price/past earnings:	**8.45x**	
Price/ forward earnings:	**6.79x**	
Price/sales:	**2.06x**	

Company Situation:

BHP Group is the largest mining company in the world, with large operations in copper, iron ore, coal and many other base and precious metals. It's based in Australia where it has large operations, but it operates worldwide, with big operations in the Americas and Africa. Its former large petroleum operation recently merged with Woodside Petroleum.

Valuation:

BHP produces a lot of things the world needs, and they operate their business pretty well. However, investors have seen that managements at the company have made mistakes in past cycles, so they are skeptical of bidding up the stock. Investors and traders may have overdone the selling this time, though, as management was able to almost double earnings over the past five years (backed by a large tailwind of trough-to-much higher commodity prices) and analysts and investors are projecting that EPS will shrink 10% a year for the next five years – too pessimistic if EVs are going to get anywhere close to the numbers projected by 2030. The company is just barely making enough to cover the dividend, but BHP is also set up to take real advantage of continued high commodity prices. Kanos owns BHP in many customer portfolios, and while we are not huge backers of management, we do think they have the right portfolio at the right time and can execute on making money from extracting value and growing opportunities from these assets.

We highlight these companies to show that even after big run-ups in price, followed by the slump we've seen in 2022 in many companies, there are some interesting valuations for putting money to work and there are some very expensive companies, even after their share prices have fallen significantly.

We are always looking at our portfolio companies and new ideas as we try to keep portfolios growing and balanced but focused on good risk/reward situations, generally over the medium- and long-terms.

If we can generalize, many of the big winners from the 2010s are still getting premium valuations from investors, while most industries that were out of favor are still out of favor, even if some have been rerated somewhat higher in value, even though circumstances have changed pretty radically – higher inflation, higher interest rates, falling demand for consumer discretionary and work-at-home goods/services and, of course, no more quantitative easing by the Fed.

We think that, as investors realize that monetary and high-debt solutions that were used from 2008-2020 are not working like they used to, market participants will shift their focus further to more "value" industries where there are many attractive investments to be made for the future.

The Managers of Kanos Capital Management
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