December 2009 Investor Letter

Fourth Quarter Market Conditions

The fourth quarter of 2009 continued the trends of the second and third quarters, with US stock markets rallying into the end of the year. However, the highs were characterized by narrow leadership (few stocks reached new highs) and anemic volume, calling into question the sustainability of the rally in December. Many stocks that in past eras would have been called speculative continued to advance during this quarter (banks, homebuilders, retailers), as did highly valued "market darlings" like Goldman Sachs, Apple, Google and others. Stock groups like banks, retailers and homebuilders were picked by traders to continue their "snap back" from their extremely oversold positions last spring. We stayed away from owning these types of companies, which hurt our performance this quarter (and year) as "'junk' triumphed over quality" again.

Reminder: We at Kanos were wary of the stretched valuations and uncertain future prospects of a number of stock groups that we think have poor long-term prospects. We try to deploy your capital for long-term prospects in sectors that we think will do well for at least the medium-term (3-5 years) if not longer. This is the result of our "top-down" look at sectors that we follow with a "bottom-up" approach to picking stocks within those sectors (as well as other stocks that have attractive valuations and prospects, even in sectors that may prove less than robust).

Precious Metals

Precious metals were a "tale of two cities" during the quarter, with extreme outperformance in November and early December, but much of October and mid-December showing losses. Gold stayed above $1,000/oz during the quarter, reaching as high as $1,220/oz in early December before falling to end the year at $1,096/oz. Silver was more volatile, trading as high as $19.20/oz, but closing the year at $16.92/oz. The US employment report released in early December showed that while employment fell, it fell by a mere 11,000 people, which spooked the precious metals markets into correcting, worried that 2010 might show rising employment and lead to US Federal Reserve ("the Fed") tightening interest rates and boosting the US dollar. Precious metals stocks did well throughout the quarter, but they suffered during the mid-December swoon and led to a subpar December performance.

5151 San Felipe, Suite 1300, Houston, Texas 77056 Phone: (713) 963-9631
Mobile: (713) 305-4001 Fax: (713) 963-9920 E-mail: kirby.shanks@kanoscapital.com

Energy

Energy markets gyrated with varying expectations of world economic growth and the advent of winter weather in the Northern Hemisphere. Crude oil prices rose into the $80s/bbl in October, but a warm November/early December drove prices below $70/bbl briefly. Crude ended the year near $80/bbl as the winter worsened and Asian usage continued at a high level. Natural gas, after rallying near $6/mcf in October, dropped under $4.50 in November but rallied with winter weather to about $5.75 to end the year. Energy equities performed well throughout, holding their value in spite of the underlying commodities' price volatility. Expected early January cold also pulled up stocks near the end of the year.

General Stock Market

Technology shares performed best during the quarter, as investors judged that companies would spend to upgrade technology as the most efficient way of emerging from the recession, and shares were driven to high levels in expectation of good 4th quarter results to be announced in January. Financial shares, while performing well into October, leveled out and did not participate in the rallies as much during November and December. Industrial shares had moderate performances as trends expected to emerge post-recession were further built into stock prices.

Commentary

"Formula for Inflation"

In light of gold's recent moves past $1,200/oz (and silver's move near $19/oz), we feel compelled to examine the reasons for the recent price movements of precious metals, and some of the commentary and events that surround these price increases. First, however, we will have to go through a short economics primer.

Fund manager and ex-economics professor John Hussman in a recent commentary summed up how inflation and deflation come about in our (and the world's) economy, and partially refutes part of the work of Milton Friedman, the founder of monetarist economics, who famously said "inflation is always and everywhere a monetary phenomenon." Hussman reminds us that the value of a good is merely the "marginal utility" of the good divided by the "marginal utility" of a dollar (in the case of domestic goods).

Value good = MU good / MU dollar

This is a fancy way of comparing people's demand at a given time for a good when compared to their demand for dollars. Marginal utility means the "usefulness, at the margin," of something. Generally, it means the demand for goods, and examples abound: in the Great Depression in the 1930s, the marginal utility of many goods in the economy fell more quickly than the marginal utility of the dollar because there was little demand for consumer goods (as unemployment skyrocketed) and for commercial industrial goods (as trade plummeted). Thus, during the 1930s, deflation occurred as the value of many goods went down faster than the marginal utility of a dollar. In the 1970s inflation, the relative lack of many goods, including crude oil but also other natural resources, was caused by shortages, raising their marginal utility compared to dollars, leading to inflation of prices.

The reason this is important is that we have had changes in the marginal utilities of both goods and dollars recently and anticipate more in the near future. Increased economic strength in the developing world combined with the easy money/rising asset prices/housing and real estate boom of the G-7 nations during the early 2000s catapulted the world to higher prices for goods and the raw materials used to make them in the 2006-2008 period. This caused the marginal utility of many goods to rise; for example crude oil moved from under $30/bbl to $147/bbl during the period. The same thing happened with US residential housing, but for different reasons: with easy financing, the marginal utility of the dollar went down compared to the house, so prices went up. When demand for goods and raw materials faltered due to their too-high costs, demand for them fell. At the same time, due to high levels of debt, demand for dollars (to pay back loans that were due or payments that were growing) grew, meaning the price of things plunged due to lower marginal utility of the good and higher marginal utility for dollars. This is what we saw in 2007-2008 in housing and in 2008/early 2009 in commodities and the economy, as expressed by plunging stock market values.

Ben Bernanke, current US Federal Reserve Chairman and Depression historian, believes that if more dollars had been created during the Depression, deflation would not have been so rampant, and he believes the economic downturn of the 1930s would have been muted because deflation would have been muted. Deflation is not a bad thing for people with a steady, well-paying job and a paid-for house; it provide lower prices in the future and allows a consumer to put off purchases of items until the value of the item's falling price makes it a bargain. However, if there is debt involved, things change. If you own a home with a mortgage, and it keeps going down in value, your equity falls much more quickly when prices fall. As prices fall further, the equity of the house can go negative, where you owe more than the house is worth. It can also happen in business – if the selling price of a company's products fall, and the business is financed with debt, if your profit margin goes negative, you may not be able to service your debt and you will be forced into bankruptcy. Thus, deflation is bad for the indebted, and since the US Government and many of our fellow citizens have a lot of debt, deflation is considered the thing to avoid.

Thus, the US Government, in concert with the Fed, is trying to re-kindle inflationary forces to overcome our recent deflationary (outright price declines)/dis-inflationary (slower growth in prices than the mid-2000s) economic forces. And they are doing so using both the numerator and denominator of our equation above. They are spending federal money to stimulate the economy, thus applying more demand to goods to try to raise the marginal utility of goods. Meanwhile, the Fed has expanded its balance sheet over the past 16 months by over 150% (or $1.4 trillion dollars) to try to lower the marginal utility of dollars. Thus, if they are successful, they will increase the amount of dollars available to banks (and the world financial system, in sequence) while the US government increases demand for goods. This should lead to, and in the past has led to, inflationary forces. The fine line is that the Fed does not want to create too many dollars, so as to have the marginal utility of dollars plunge and push prices up in all dollar-denominated goods.

If the financial market believes that the government and Fed are successful at heading off deflationary forces, one place we should see a reaction will be the bond market, and specifically, long-term bonds, especially Treasuries. 2009 saw 30-year Treasury rates rise between 1-2%, meaning long Treasuries lost around 30% of their value (albeit from a time of extreme fear/uncertainty during January/February with the US banking system). If Long Treasuries move from their current yields of around 4.50% to yield approaching 5.50-6.00% or higher, we will know that inflation expectations are taking hold.

However, Bernanke et al. don't want long rates to go higher, because that means financing for mortgages or new infrastructure projects will cost more, meaning economic activity won't be as robust. In addition, the US national debt will become much more expensive to finance, meaning more and more money will have to be borrowed just to pay interest on the debt! So Bernanke and the Fed governors are walking a fine line where they are trying to defeat deflation, but just have a little inflation, not enough to send long bonds higher. It is a virtually impossible task, but if Bernanke can get inflation to re-appear BUT ONLY A LITTLE, he will have done a masterful job. And one way to rein-in inflationary expectations for the future is: continue to talk about how you will be withdrawing dollars from the financial system, discontinue monetary stimulus, better regulate banking reserves through new tools such as paying interest on reserves held at the Fed, etc. Also, a little inflation is also attractive on the surface; inflation makes people's paychecks rise yearly (in nominal terms), people's assets have higher (nominal) values, etc.

So, how does gold figure into the situation now? Gold has been money for thousands of years, and it has been identified as a store of value by central banks for as long as there have been central banks. Gold is a reserve currency that rivals dollars, euro, yen and other currencies.

US efforts to revive its economy, discussed above, have not happened in a vacuum. The low level of the dollar compared to the last couple of decades means that US goods are more competitive than traditional sources of imports, meaning that domestic goods are attractive and have taken market share from imports. Other countries' industries, wanting to export goods to the US, the world's largest consuming nation, pressure their national leaders to lower their currency to be more competitive with the US dollar. Other countries like China (most conspicuously) "peg" their currency to dollars, meaning they keep the value of the Chinese Yuan constant with the dollar by purchasing dollars and issuing Yuan. Thus, as the US has continued to increase money supply to invigorate economic growth (and most recently to fight deflation), other countries have also created massive amounts of their currencies to stay competitive with the US dollar. This "competitive devaluation" has been accompanied by lower interest rates, so savers and people trying to preserve capital have looked for places to invest their capital to preserve its value as currencies have depreciated. Gold has been the beneficiary during the 2000s, and 2009 was the year the gold passed $1,000 an ounce and may stay above that level.

The fourth quarter of 2009 was very good for gold, as discussed above, and we believe 2010 and beyond will continue the march upward of gold prices. The reasons are as follows:

1) <u>Central banks, long sellers of gold, have, in aggregate, turned into buyers</u> – when interest rates were higher and central banks wanted yield on their reserves to try to use returns on their capital, a number of European governments / central banks sold gold during the 1990s/early 2000s. But as US dollar reserves have ballooned while the value of the dollar dropped and yields fell near 0%, central banks have become gold buyers in size. For example, the Russian Central Bank bought 134

tonnes of gold in 2009, including more than 46 tonnes bought during the 4Q2009. Couple that with India's purchase of 200 tonnes from the IMF sale of gold (along with smaller sales to Sri Lanka and Mauritius) and China's intermittent announcements of higher gold holdings, and what was a headwind becomes a tailwind for the price of gold.

2) Gold production has been falling worldwide for years – 2001 was the peak of world production at approximately 2,600 metric tonnes; 2008 production was 2,356 mt, down 10% from 2001 and 3.7% compared to 2007, according to Goldline International. And this is during a timeframe when gold went from $260/oz in 2001 to over $850/oz in 2008 (briefly topping at over $1,000/oz in March). One would think that gold production would grow during a time of increasing prices and at a time of increasing money supply, but it hasn't, held back by higher finding costs, longer mine permitting periods and environmental opposition. Thus, slowing rate of production of gold should lead to higher prices of gold.

3) US Government expenditures will continue to grow – the yearly budget deficits are projected to be over $1 Trillion for the rest of Obama's term, and the political will to reduce expenditures is nowhere in evidence. The selling of US Government debt will be difficult as more and more will be created while old debt will need to be rolled over. The Fed, in its 'Quantitative Easing' plan unveiled last March, bought $300 billion of Treasuries (and $1.2 trillion of mortgage debt) to help keep down interest rates, especially mortgage rates. We believe that the Fed will have to step up and be the 'buyer of last resort' when (not if) Treasury auctions of long bonds fail to find all the buyers needed. This, of course, will lead to more dollars created to pay for these bonds, decreasing the "marginal utility" of dollars. More dollars should push up the price of gold.

4) "Real" short-term interest rates are negative – Short-term rates, as measured by Fed Funds rate (or other short-term rates, like Treasury Bills) are below the rate of inflation (as measured by the government's Consumer Price Index) by at least 1.8%, meaning that prices are rising at a higher rate than cash returns. In the case of precious metals, the cost of holding them is very low, and the opportunity cost of holding them (as opposed to a T-Bill or money market fund) is near zero. Thus, in times of negative real rates, investors are drawn to tangible assets like gold to preserve their capital. Real rates were very low or negative from the late 1960s through 1980, and gold moved from $35/oz to as high as $850/oz. Real rates have been very low or negative since 2001, and gold has moved from $250/oz to over $1,000/oz. The Fed has maintained its stance that short rates would stay near zero "for an extended period of time" (which has already lasted more than one year), and they have so far not changed the language or their stance on rates, thus seemingly keeping rates low for 2010 (at least).

5) <u>The Fed IS the market for mortgage bonds</u> – the Fed, also in its 'Quantitative Easing' Plan from March 2009 pledged to buy $1.2 trillion of mortgage bonds to keep mortgage rates down. The plan was extended last fall so that it would end in March 2010 to 'spread out purchases over time' according to the Fed announcement. What quickly has become apparent is that the Fed is the only buyer (in size) of mortgage debt, and that if the Fed/Government want to keep mortgage rates low after March, then 'QE2', the follow-on quantitative easing plan that we anticipate will have to be enacted, will again lead to more money creation by the Fed. In fact, Bernanke, in one of his recent speeches, alluded to the fact that there may be need to continue purchase of mortgage bonds, giving credence to a second plan of quantitative easing. More QE is expected to occur, and the dollars created should push up gold prices.

6) <u>Bernanke is still in denial about the effects of low interest rates</u> – In a speech given to economists on January 3, 2010, Bernanke said that the 1% Fed funds rate that the Fed set in 2003-2004 did not contribute to the housing bubble and were "appropriate" for the time, due to disinflationary concerns about prices in the economy. While this rhetoric could have been politically motivated, that the Fed Chairman would deny that interest rates were a large contributing factor is troubling and at best disingenuous. If Bernanke is truly of this mindset, he is liable to leave the Fed funds rate near zero throughout 2010 and at least part of 2011, further contributing to inflationary pressures which should express themselves at least partly through rising gold prices.

7) <u>2010 is an election year</u> – Much of the Congress is up for re-election, and the Fed generally does not change monetary policy as we approach elections so as to advantage/disadvantage the incumbents vs. their election opponents. Now that Obama's and the Congressional Democrats' agenda is coming under fire, don't expect the Fed to tighten monetary policy and potentially make the macroeconomic environment more expensive to finance.

One more point on gold – many financial commentators, having watched gold climb in price in recent years, are afraid gold could be in bubble, that it has gone too far, too fast. Nouriel Roubini, Columbia University professor and one economist who called the financial collapse of the mortgage and debt markets in the mid-2000s, wrote an article in mid-December saying he thought gold was in a bubble. In response, Lee Quaintance and Paul Brodsky of QB Partners, an institutional investment company, wrote a cogent response to why they disagreed vehemently with Roubini's claim. We thought it would be instructional to reproduce some sage portions of their response, which also gives us more reasons as to why gold is an appealing investment currently:

> *"We would argue that the magnitude of past, current and potential money printing may be easily quantified by calculating a Shadow Gold Price (Monetary Base [in the world] divided by official sovereign gold*

holdings). Presently, our 'SGP' is multiples higher than the current nominal public gold price. To display "bubble-like" characteristics, gold would need to trade at a meaningful premium to the SGP, as it did at its speculative peak in 1980. At current levels, that price is multiples of the current spot price of gold. In fact, spot gold currently trades at an 85% discount to the SGP which, we'd be remiss not to highlight, indicates forcefully that it is the U.S. dollar and other fiat currencies that are currently in a bubble. ***[This implies a gold price of over $6,000/oz – KS]***

"The global gold price responds to an increase/decrease in banking system reserves (monetary base), not debt deflation itself ***[which is what we are seeing in this deleveraging process – KS]****. The causality here is that in our modern system of central banking, private sector debt deflation is fiercely combated with monetary base inflation* ***[money printing by the Fed – KS]****. Gold behaves in the markets as though it were the reserve asset "backing" the monetary base. As the monetary base expands* ***[or is expected to expand by investors/traders – KS]*** *and gold reserves do not, the nominal price of gold is biased to upward adjustment.*

"[Roubini argues that gold has no intrinsic value]…Gold has no less intrinsic value than paper money, except that paper money is currently sponsored by global governments (by fiat). The military, taxing and monetary powers of discrete governments do not make them global price setters of private goods, services and assets.

"The only metric we can cite that can logically define the relative intrinsic value between the dollar and gold is their respective costs of production. Gold is definably scarce and costly to produce. Dollars are infinitely printable at a direct cost approaching nil. In the end, sovereign debt is vulnerable to further debt deflation pressures, which will require creation of even more bank reserves, which in turn should make gold even more relatively scarce against dollars.

"Dr. Roubini is not alone in thinking a rising gold price should come in anticipation of a nominal economic recovery that would lead to an expansion of total bank credit, commensurate with the expansion of the monetary base of the last 18 months. However, the bull case for gold is the exact opposite: ***gold anticipates contracting total bank credit (continued debt deflation), which requires further monetary inflation to be administered by central banks.*** *This seems to be a common misunderstanding among economists, as well as high profile investors currently espousing negative AND positive views on the anticipated direction of the gold price.*

> *"[Roubini believes there is more deflation than inflation due to slack in the goods and labor market]…Slack in the goods and labor markets are harbingers of further risk asset deflation. Further risky asset deflation is a harbinger of further debt deflation. Further debt deflation is a harbinger of further monetary inflation. Further monetary inflation is a harbinger of higher gold prices. Such is the chain of causality we, and the global markets, recognize."*
>
> *- from Welling@Weeden, December 18, 2009*

Dichotomy of Investment Viewpoints

While we risk repeating ourselves from past letters, we think it is important that we highlight how diverse opinions are concerning our economic and investment future. There are a near-record of investment managers who think we have entered a new bull market, following the "Great Recession" of 2008-2009. There are fewer bears, but many prominent investment managers and commentators believe there is more "house cleaning" that must be done before we have purged the excesses of the 1980s-early 2000s. And there are those somewhere in between that believe that the worst has been seen, but we will "muddle along" in the "new normal" which will be slow growth, continued high unemployment for awhile. We at Kanos are somewhere between the last two camps.

The longstanding Fed macro-policy of lowering interest rates in the face of slowing economic growth (or even perceived economic upset, like the Y2K "crisis") has led to a buildup of debt in the financial fabric of the world and a reliance on the carry trade (borrowing cheaply short-term to buy something of longer duration that pays more) over the last few years that now is in jeopardy. The world, and the financial system in the US especially, is going through a deleveraging process, where debt will either have to be paid back, defaulted on, or "worked out", where the borrower may have to pay back just a portion of the amount owed. In order to keep the US economy from staying in a severe recession as this deleveraging occurs, the Fed has lowered short-term interest rates to rock bottom to advantage borrowers (like large financial institutions) while they take their losses on those assets that must be sold or have defaulted due to high leverage and poor economic decisions.

We believe that this deleveraging and rocky, slow financial recovery from the recent recession will cause companies to experience slow growth (or no growth or possible continued negative growth) in their revenues over the next couple of years, meaning new hiring will be much more feeble than coming out of past recessions and demand for products will also be much less robust. This pessimism about expected growth will eventually lead to "margin compression", where stocks' P/E ratios go down, which will push stock prices down unless their earnings are rising at the same time.

With respect to the general investment climate in the US, we are struck by the complacency and reliance on history that characterize many people in the investment world presently. Many people for whom we have a lot of professional respect are predicting a "V" shaped recovery, where GDP will grow at 5% for the next several quarters, the unemployment rate will drop quickly, and one will be able to "feel" the economic recovery occurring (whereas today many people still feel like the country is in recession due to a lack of job creation, failing businesses, lack of ready, spendable cash, etc.). Why do they feel this way? There are a number of reasons but the main one is historical pattern matching.

Generally, people have taken past **post-World War II** recessions and applied statistical analysis to this recession: they generally last less than one year, drop GDP for 3+ quarters, end when a number of indicators turn up, and birth new booms in the economy, with concomitant bull markets in the financial markets. While we certainly don't dismiss this type of analysis, as noted above, we don't believe this is your "garden variety inventory-correction" type of recession. So we will run through a list of bullish arguments and list reasons why they may not apply to our current economic downturn.

1) Key indicators show recession has ended and recovery begun – Dennis Gartman, technical analyst, investment manager and commentator who writes The Gartman Letter has a set of indicators he uses to find the end of recessions. These generally occur within a couple of months of each other, and in 2009, they did occur mid-year, signaling to Mr. Gartman that the recession had ended and the recovery begun. The first of his indicators, that the Weekly Jobless Claims number peaked and a few weeks later spiked down and stayed at a lower level, occurred in June/July – this pattern occurred just as it had in most of the postwar recessions. Second, average weekly hours worked in manufacturing fell to 39.4 in mid-2009 (just as they had in recessions of 1969/70, 1973/74, 1981/82, 1990/91 and 2002/03) before rebounding. Third, the ratio of The Conference Board's Lagging Economic Indicators to Coincident Indicators, which had marked the bottom of every recession since 1961, bottomed in early summer 2009. And fourth, The Conference Board's Diffusion Index of Lagging Economic Indicators touched the "zero" point in March 2009, which in past recessions has market the bottom of economic activity. While all these statistics are impressive, they usually signal a time when financing is readily available, materials are cheap and plentiful, savings are building up, and government is trying to spur the economy through business-friendly policies. However, we see 2010 where the government is antagonistic to banks and trying to raise taxes, applying stimulus but in a political and jobs-friendly way that does not target businesses particularly, banks unwilling to lend due to much lower risk of lending to governments through purchasing government bonds, and raw materials that may not be plentiful when the economy finally starts to recover. The economy is far more like the mid-Great Depression economies of 1930 and 1936 where

fledgling economic growth is not being spurred enough to cause large-scale expansion of businesses and widespread economic risk taking.

2) Investment managers are using the timeline of past downturns to make investment decisions that may not reflect current conditions – a good example of this is the similarity of the 2002/2003 pattern in the stock market to the current market. After the dot-com bust of 2000 and the recession that followed, the stock market hit a bottom in October 2002, tested this bottom in March 2003, and the economy and markets recovered and prospered for the next few years. There are managers and market analysts who saw the extreme selling of October/early November 2008 and the final bottom of March 2009 as the same dynamic, postulating that the extreme drop in economic activity and the markets washed out the excesses, setting up the economy for a robust recovery and the stock market for a new bull market. However, the differences in the two are stark: the 2001-2003 downturn saw the consumers only partly affected by the recession. It was an "industrial" recession, where misallocation of capital during the 1990s led to huge overbuilding of industrial infrastructure (fiber optics, buildings, etc.) while consumers reaped the benefits. Also, leverage was rationalized in the commercial sphere, and consumers' balance sheets in aggregate were healthier – thus paving the way for renewed economic growth, since consumption made up nearly 70% of the economy. In 2009/2010, consumers', financial institutions' and companies' balance sheets are still leveraged, meaning continued deleveraging should have a "headwind" effect on the renewal of economic growth, and the continued existence of so much leverage in the system means this year will probably not look like 2004 (after 2009 looked so much like 2003).

3) Unemployment is a larger and more difficult problem than in past recessions – US Government statistics have been expanded in the past twenty years to create statistics that make employment numbers look more attractive, but the unemployment statistics are still measured in the former methodology as well, and this U-6 measurement (the broadest measurement of unemployment) says that the US is still over 17% unemployed (having reached that figure starting in September 2009). In contrast, this broad U-6 unemployment measure peaked at 10.4% in November 2003, up from a trough of 6.9% during 1999 when the economy was "hitting on all cylinders". In addition, today's workforce is larger, so 17.3% of the working population is a very large amount of people for whom to find jobs. This is especially true in light of the permanent downsizing of the mortgage, automobile and consumer financing industries. The current administration's "solutions" to the unemployment problem are currently pushing the economically-challenged alternative energy industries and growing government employment. We expect these initiatives to have little effect on cutting down unemployment in the near term.

4) <u>Recessions "always" end in "V" shaped recoveries; sometimes it just takes longer</u> – these views are put forth by the financial analysts who have pulled out the "post-recession playbook" in which you invest in a sequence: early cyclicals include automobile, building materials, household equipment, retail and homebuilding stocks. As mentioned above, many companies in these industries with poor fundamentals have rallied as managers run their "playbook". Late cyclicals, like energy and mining have lagged for the same reason, as managers overweighted early vs. late. We continue to believe that many industries have been permanently altered by the events of the last few years, and we believe many early cyclicals will not recover like in past recessions: 1) autos – the industry is very different, with the US government in control of GM/Chrysler and employment permanently lower. Without private ownership and innovative new designs, the industry promises to be moribund for awhile 2) building materials – with both residential and commercial space still glutting the market, new building due to capacity constraints seem years away, 3) household equipment – same analysis as building materials, 4) retail – retail expanded virtually without pause throughout the 1990s/2000s, and the overexposure of retail outlets, the expansion of online retailing and the relatively low level/lack of growth of consumer discretionary spending seems to mean retail will be retrenching rather than expanding, and 5) homebuilding – as mentioned above, still high inventories of houses for sale combined with continually falling prices appear to doom recovery prospects in 2010 (at least) for homebuilders. Thus, these stocks, which have rallied hugely since the March 2009 bottom, have not had their fundamentals improve much in spite of having emerged from recession at least six months ago. This shows that these and many other stocks are vulnerable if the economic "V" fails to emerge.

The credit creation that led the US to an ever more leveraged economy starting in the 1960s has finally peaked, and the time needed for the US economy to deleverage will hamper growth for at least a couple of years. The government and Fed will continue to try to stimulate, which will at some point lead to an inflation problem due to extreme monetary creation. The resulting next recession will finally do the job the last recession failed to complete – adjusting investors' expectations to former levels of valuation (leaving behind "bubble" mentalities) and making consumers live within their means, after debt is defaulted on and bankruptcies/foreclosures again become a social stigma.

Thoughts for the Future

So what does all this mean? Our perspective has changed as many stocks defied their fundamentals and rallied despite continued economic malaise. However, our outlook has not changed; we still believe that "post-recessionary" responses by authorities will look a lot like those measures applied during the recession itself:

- The Fed will continue with its easy money policy despite calls for rate hikes. With mainstream unemployment staying stubbornly over 10% (and true U-6 measurements of unemployment staying over 17%), the Fed will have to shade policy action toward trying to encourage employment, keeping rates low.

- Spurred by continued popular and political pressure to keep mortgage rates low to encourage more potential homeowners, we believe the Fed will institute a new round of Quantitative Easing, where the Fed continues to buy mortgage securities from financial institutions, thus keeping mortgage bond prices up and mortgage rates down. To facilitate this, the Fed will also buy more Treasury securities, so that long-term rates, as defined by Treasuries, don't separate from mortgage bonds.

- In spite of promising recent election results in Massachusetts (senate), New Jersey (governor) and Virginia (governor), we believe US Government policies will only change glacially, meaning large budget deficits made worse by continuing foreign wars, huge new borrowings by the US Treasury and perhaps some stimulus packages to try to jump-start an economy that does not seem to respond to growth initiatives are what we should expect.

- Large banks will continue to repair their balance sheets and put much of their capital into government securities and trading operations and less into new lending. Small banks are lending but not on the scale to get the economy moving without more activity from big banks.

- Asian economies, along with some Latin American economies, will continue to provide the world with growth engines. Demand for materials and consumer goods will sustain East Asian, South Asian, Brazilian and even Middle Eastern economies.

- Commodities, especially precious metals and crude oil, while experiencing a lot of volatility, will end up at higher levels than early this year as investors try to preserve their capital and find the supply/demand balance appealing. Real estate will recover some of its value as nominal values rise as inflation takes hold.

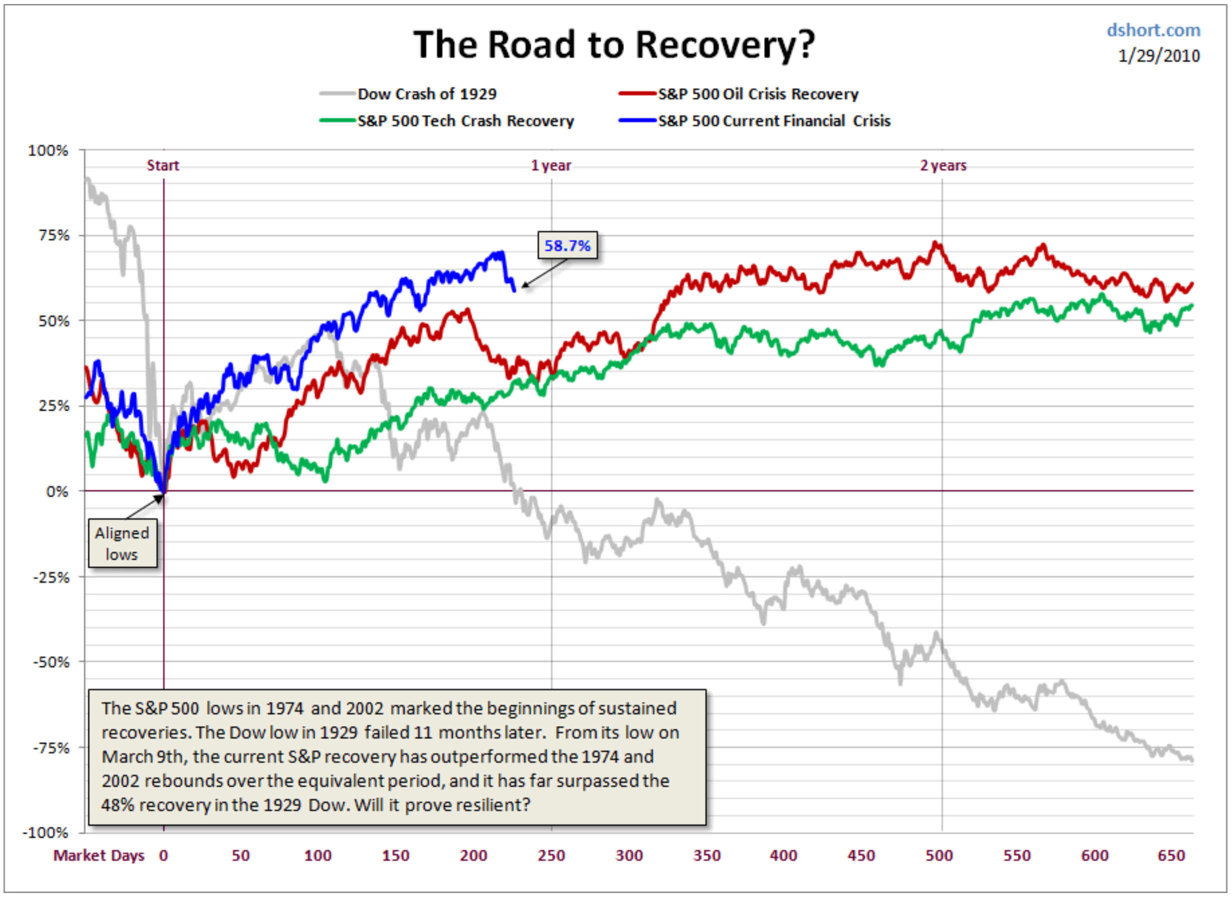
- The US financial markets will experience increased volatility, falling when growth expectations falter and rallying as Asian and Latin American demand helps spur (slow) economic recovery in the US. Valuation levels will generally fall as sustained growth fails to materialize, but world growth allows US markets to avoid an epic collapse.

We believe that a number of industries will have improving fundamentals over time, and look to add healthcare, technology and industrial companies as valuations come into line with expectations.

We will, as stated above, see times of volatility, pushing prices against us. We are currently (December 2009/January 2010) in a period where many bulls are anticipating withdrawal of monetary stimulus because of "less bad" unemployment statistics, the slowly recovering US economy, return to "trend growth" of many Asian/Latin American countries, and the tightening of monetary policy already seen in Australia (raising short-term interest rates) and China (raising rates, raising reserve requirements at banks, publicly discouraging growth in bank lending). We believe that these will turn out to be short-term phenomena, and economic thinking will return to stimulating moribund US and European economies and more expansive monetary policy. Until this happens, we will try to have our portfolios withstand the money flows that move in opposite directions to the longstanding macroeconomic trends. Traders make money by establishing positions to benefit from short-term market movements, and counter-trends to the larger trend – in this case, weak economic recovery, followed by further rounds of government fiscal and monetary stimulus – are going to happen when data appears that could support the opposite result. We don't believe that recovery will be robust, however, because so much debt is still to be "rationalized" and so much governmental intervention is providing demand that withdrawal of this now-constant stimulus will cause almost immediate economic "relapse".

We also cannot forget that we are not "out of the woods" on an economic downturn that could still mirror the largest "leg down" during the Great Depression. After the 1929/1930 crash, the 1930/1931 recovery took stock prices back up nearly 70% from the lows. This recovery was followed by a huge downdraft that took the US stock market down approximately 90% from the 1929 highs. We have just experienced a huge drop from the October 2007 highs to the March 2009 lows, and now have seen a nearly 64% rise from those lows. We hope history does not repeat itself here.

The graph on the following page aligns the lows in 1930, 1974, 2002 and 2009. The 1930 lows didn't "hold", as the economy fell into deep depression, after stimulus didn't prove enough, monetary policy was not "growth oriented" and the Smoot-Hawley tariff severely hurt international trade, restricting off economic trade that linked world markets. In 1974, the shock of higher oil prices were soon incorporated into the world economy, and the US economy and stock market slowly but surely recovered. In 2002, consumer balance sheets were relatively healthy compared to business balance sheets, and the very low interest rates that occurred in 2003/2004 helped boost demand in the US consumer segment and developing world. In 2009/2010, the developing world is still a source of economic strength and expansion, but the US and European economies have large amounts of debt, high unemployment and little economic vitality to drive the recovery after inventory restocking and satisfying pent-up corporate infrastructure demand.



Let's hope that the US Government, the Fed, US businesses and economic growth from the developing world work together to keep us from sinking into a mid-1930s malaise.

The Managers of Kanos Capital Management