Fourth Quarter 2011 Investor Letter

Fourth Quarter Market Conditions

In the financial markets in general, the third quarter continued to exhibit the volatility seen earlier in the year as concerns about the European Union, combined with uneven economic statistics in the US and Asia, led to investor schizophrenia and gyrating markets. Amazingly, for the year, the S&P 500 Index closed at 1257.60, up only 3.64 points (before dividends). However, it moved 3,193 points during the year, showing the extreme volatility that intensified during the second half of the year.

October was a market "up" month, with most financial markets rebounding from September's drubbing. The S&P 500 was up almost 11% with materials, energy and financials leading the way higher; consumer staples, telecom and healthcare sectors lagged. Oil was the big winner, rising from near $80/bbl to over $93/bbl with gold also rising almost $100 to close the month around $1,725/oz. Bonds fell in price, rose in yield and the euro rebounded against the US dollar.

November closing prices were little changed from October, although there was a lot of intra-month activity. The S&P 500 lost 0.5%, with consumer staples and energy moving higher and financials and information technology performing poorly. Europe took center stage as various different bailout plans led world markets on a daily rollercoaster ride. Crude oil continued its tear, ending the month above $100/bbl on continued supply concerns and increasing worldwide usage. Precious metals ended nearly unchanged from October, with gold oscillating around $1,750/oz and silver ending the month at almost $33/oz. Bonds gained during the month, as investors moved money into the US from Europe. The euro gave back October's gains as the US dollar was strong through the end of the month against all currencies.

December was dominated by increasing volatility due to European concerns as was November. US stock markets ended little changed for the month despite huge movements in stock prices. The European Central Bank (ECB) extended three-year, low-interest loans ("LTROs") to European banks in exchange for lower-quality collateral (read: European bonds), buoying world stock markets but barely stabilizing European bond markets, leading more capital to seek a home in US dollar-denominated fixed income. Dollar strength hit commodities (except for energy) very hard, leading to a big selloff in precious and base metals. US Treasuries were bid up as capital looked for safety, and a record amount of euros were deposited with the ECB as inter-bank distrust grew. The S&P utilities, healthcare and consumer staples sectors rose in price during the

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month, while materials and energy lagged, led by the poorest performers: the mining stocks – hurt by high energy costs and lower commodity prices.

Precious Metals

In the fourth quarter, the metals, in a sense, re-enacted the third quarter. Gold and silver both did very well in October, rising significantly after September's large drop, much like what happened in July. In November, prices initially rose, then corrected, then rose again at the end of the month – much like the price action in August. Unfortunately, December ended like September, with a mid-to-late month downdraft. In both cases, the precious metals and many large mining stocks had outperformed the market up to that point in the quarter; it seems that profit-taking, extreme momentum trading caused by the initial downdraft and trend-following computer programs combined to drive down the price of the metals at the end of the quarter. Demand also lagged as Indian buyers postponed further gold purchases due to the weakness of the Indian rupee versus the US dollar, making gold more expensive in India, the largest annual consumer of gold. Interestingly, neither platinum nor palladium exhibited the extreme price movements of gold and silver; in fact, palladium, a platinum-family metal mostly used as a cheaper (but less efficient) substitute for platinum in automobile catalytic converters, was up for the month.

The mining stocks, while suffering from the drop in the underlying metals prices, did not drop in price as much as in prior sell-offs. This implies that the gold/silver price drop was a correction, not some larger, longer-term trend change. A number of mining stocks, two of which were in many of our portfolios, had operational issues that caused severe price drops, hurting our performance. We believe that the mining business, which has mishaps at times, is still undervalued, and that the metals in the ground are more valuable than the market currently "thinks". Thus, we believe that our continued overweight of metals mining stocks, while painful in the short-term, will be very profitable in the future. ***[Mid-January update: the LTROs mentioned above are more and more being considered the equivalent of quantitative easing in the US and Japan, and so far this month, precious metals and mining shares are up strongly from their December closing prices, confirming our investment thesis.]***

Energy

The energy complex was the star of the fourth quarter, with West Texas Intermediate crude oil (WTI) rising from its October closing price of under $80/bbl to over $100/bbl at the end of December. Crude oil prices benefitted from global unrest (primarily in Iran and Nigeria) and tighter supplies, as stocks of crude oil and some refined products were drawn down during the quarter. Natural gas prices, after bouncing in October, continued their seemingly inexorable drop, reaching a multi-year low in December around $3/MMBtu. Much of this price drop was caused by unseasonably warm weather throughout the US Midwest and East Coast regions during November and especially in

December. The high price of crude oil and oil products produced from the liquids often associated with natural gas were engines of continued drilling for petroleum; low natural gas prices were not enough of a disincentive to limit production of high-priced crude and natural gas liquids. ***[Mid-January update: the trends continued, with crude oil staying stubbornly above $100/bbl and natural gas prices continuing to fall, currently $2.35/MMBtu as cold weather has failed to materialize to any large extent.]***

Other Markets

Longer-term bonds, last quarter's outperformers, ended relatively flat for the quarter after a drop in price during October (as stocks outperformed). They then recovered during November and December as growth concerns and fear in Europe drove capital into US Treasuries. Corporate bonds gyrated during the quarter, but ended higher as rates dropped and investors looked to good corporate credits for safety and yield.

International equity markets, huge underperformers for the year, seesawed during the fourth quarter, but ended up from their September 2011 lows. European markets, like the German DAX index and French CAC-40, rose during October, gave back those gains during much of November, then recovered in late November/December to finish the quarter up (with most indices rising 7-9% during the quarter, although for the year the Eurozone markets were down 18%). Russia's RTS and Brazil's Bovespa followed the same pattern, posting almost 10% gains for the quarter to recover some of the disastrous losses of earlier in the year but still finishing down 18% (Brazil) and 20% (Russia) for the year. Indian and Chinese stock markets ended the year down 25% and 22%, respectively.

Focus Stock

This quarter we highlight **Canadian Oil Sands, Ltd. (OTC: COSWF, also traded in Toronto [TSE:COS])**. COSWF is one of the largest producers of synthetic crude oil in the world. The company is a large-cap producer of oil from oil sands; it owns a 36.74% stake in the Syncrude Joint Venture in Alberta, Canada.

Canadian Oil Sands (and predecessor entities) date back to 1978 when Syncrude first started operations. The Syncrude Joint Venture is a large extraction and processing operation that digs up oil-laden rock known as bitumen (pronounced "bit-chu-men" in Alberta), transports it to large processing refineries in the area known as cokers and "cooks" the hydrocarbons out of the rock – upgrading them into very high-quality synthetic crude oil. Syncrude has three large leases in which it mines bitumen (two in operation, one to be developed) and three cokers on-site near Fort McMurrey, Alberta. The process requires a substantial amount of energy to refine the bitumen, and Syncrude uses cheap, abundant North American natural gas as its energy source. The finished crudes are sold into the Edmonton refinery market or transported and sold into refinery markets in Eastern Canada or the US Midwest via existing pipelines.

The investment thesis is straightforward: COWSF, through its partial ownership of Syncrude, has an estimated 44 years of bitumen reserves in the ground (27.8 years of proven reserves) – thus, there is no exploration risk. The cokers use low-priced natural gas to turn the bitumen into premium grade synthetic crude oil, which typically sells for a premium to WTI due to its superior grade. Canada, and Alberta in particular, represent a relatively stable political and regulatory jurisdiction, and Canada and the United States together make up the largest market for petroleum products in the world.

The three major investment drawbacks to COSWF have traditionally been 1) the single source facility, 2) the complicated (and sometimes erratic) operation of the cokers, and 3) the lack of growth. Since the cokers and bitumen "mines" are all situated in one location, a natural disaster could disable operations in a worst case scenario. Operational upsets have happened with unfortunate regularity as the hostile climate and complicated processes have led to less-than-smooth operations over the years. ExxonMobil, a part owner through its partially-owned subsidiary Imperial Oil, took over as operator in 2009 to improve operations; subsequent operational upsets have been fewer, but still occur, leading to less than optimal utilization. These operational mishaps have impacted Syncrude's ability to grow; however, they have a project in the works to debottleneck operations which would add capacity (it will most likely be several years until these plans can be approved and implemented).

We believe the negatives mentioned above are magnified in Canadian Oil Sands Ltd.'s stock price. Thus, we see COSWF as very attractively valued, with a 10x trailing P/E ratio and a 2012 P/E projected at 10x. The trailing operating cash flow ratio is approximately 7x, while the forward EV/EBITDA (rough cash flow) is expected to be closer to 6x. COSWF trades at approximately 2.9x tangible book value, but that comes out to **only $6.54/bbl for proven resources in the ground**. With Syncrude selling its crude in Canada for over $105/bbl during the first half of January, the economics of the operation appear extremely attractive. The company formerly was a Canadian energy trust, which sheltered income from taxes (similar to Real Estate Investment Trusts or Master Limited Partnerships in the US), but the structure was changed three years ago and taxes will be due on profits starting in 2012. In spite of this, COSWF is expected to pay dividends in the 5-6% range going forward, depending on the realized sales price of its crude oil.

The long reserve life, the premium quality of crude oil, Canadian locale, use of cheap natural gas for its energy needs and attractive valuation/dividend yield, have led us to make Canadian Oil Sands, Ltd. a core holding in our portfolios.

Kanos Quarterly Commentary

It Sure Seems Like 2008!

"History doesn't repeat itself, but it does rhyme," is a quote often attributed to Mark Twain. When applied to the worldwide economic situation in 2011 relative to 2008, there is a lot of truth to this oft-quoted saying.

Remember 2008? The world was in the midst of a tumultuous financial situation, with a number of banks loaded with bonds of diminishing quality and one major class of bonds facing imminent downgrades and possible default. Commodity prices were high, in spite of expectations of weaker future demand (with some expectations of recession in the developed world). The US government was in a partisan deadlock, with an unpopular president and an equally unpopular opposition Congress frustrating each other and seemingly unable to reach even basic compromises. US monetary policy was expansionary, trying to keep economic growth underpinned – but many argued there was plenty more the Fed could do…

Fast forward to late 2011: The world is in the midst of a tumultuous financial situation, but instead of subprime mortgages, it is sovereign debt of the 'PIIGS' [Portugal, Ireland, Italy, Greece and Spain] countries facing 'haircuts' in value or possible default. Commodity prices are again high, with crude oil stubbornly over $100/barrel and most grains almost 100% higher than their norm of the past many years. The European debt crisis, coupled with still-falling US housing prices, a surplus of labor and factory capacity worldwide, and still-high consumer (and now governmental) debt levels, points to slow economic growth or recession in the future. The US government is back to a nasty, partisan deadlock, with the roles reversed: Obama the Democrat as president and the Republican House of Representatives blocking much of the 'non-frugal' policies of the Democratic administration. US monetary policy under Fed Chairman Ben Bernanke continues to be expansionary, but not to the extent many people believe it should be, as the drumbeat for further quantitative easing slowly builds.

We know what happened in 2008, but as Twain quipped: history rhymes, it doesn't repeat. So what's different in 2011/2012? Actually, quite a bit is different, and in some cases is more dire:

1) Private debt levels (business, financial and consumer), while extreme in 2008, have not fallen much, and government debt levels have exploded higher through 2011 due to (mostly futile) attempts to stimulate the developed countries' economies in the last three years into a typical economic recovery;

2) The higher national debt levels have made governments, which were the saviors of the financial system in 2008/2009 when they could provide capital to financial entities and other "systematically important"

companies, less effective. Governments are maxed out on debt capacity, meaning only private capital or monetary stimulus from central banks will be available [in size] to help recapitalize financial systems;

3) Developing countries' economies, while still growing, are not nearly as robust as they were in 2008. Three years of recession/anemic recovery in the US and much of the developed world has made Asian and Latin American export economies slow down as demand for goods remains on the weak side;

4) In spite of all the above factors, commodity prices continue to stay stubbornly high. Winter oil prices above $100/barrel are a big concern because summer oil demand for transportation could further sap oil supplies and drive prices even higher. In spite of much better growing weather in the US Midwest (and in Russia and Ukraine) this summer/fall, crop prices around the world have stayed stubbornly high as demand has not slacked off and poor crop yields in South America (especially Argentina) have buoyed prices. Metals prices, in spite of a couple of large fall/winter price drops, have stayed higher than many thought, with copper still hovering above $3.50/lb (down from $4.50/lb earlier this year but higher than the <$1.00/lb price during much of the 1990s), and gold and silver still at pre-2011 highs of $1600/oz and $29/oz, respectively. In spite of surpluses in labor and factory capacity, inflation has stayed at 2% or above due to demand for food, fuel and other items resulting in consumer inflation that further strains current standards of living. Part of the current economic situation is caused by negative real interest rates, where inflation is higher than interest rates, incentivizing capital to be invested in hard assets rather than depreciating cash investments/bonds;

5) Demand for very short-term government bills and inter-bank lending, often barometers of financial confidence, are showing extreme readings. One-week and one-month US T-Bills traded between 0.02% (annual rate) and -0.01% during the quarter. In early January, Germany auctioned off six-month "Bu-bills" (Bund bills – German equivalent to US T-bills) that yielded a negative rate, -0.0122%, and Bu-Bills in the secondary market have traded slightly negatively (at times) over the past couple of months. This, of course means the investor is **paying the government for the privilege of lending money to it**. This phenomenon is usually caused by fear of return of one's principal in more traditional cash investments. In addition, European banks have been putting their overnight excess funds on deposit at the ECB, instead of doing repos with other banks which would yield higher returns. Why? Because European banks are not confident that other European

banks (French and German banks included) are good enough credit risks – **even overnight**. In addition, a number of large European companies have bypassed banks entirely and deposited their cash balances directly with the ECB. Meanwhile, other large corporations are lending to European banks overnight, turning the traditional bank-company relationship on its head; and

6) The ECB's balance sheet has grown to eclipse even that of the Fed, as the LTRO loans of late December have pushed the ECB's assets over $3 trillion. Meanwhile, the Fed has extended "swap lines" or reciprocal lending facilities to the ECB (and other central banks) to provide a source of dollars to worldwide banks. The swap lines are backed, of course, by currency issued by each central bank (e.g. the ECB backed its swap line with the Fed with euros).

So, what's going to happen? The world went through 2008 and came out on the other side with large investment losses and a weakened financial system, but another deep depression was averted, at least for the time being. The investment world is completely bifurcated with huge sums of capital being invested in completely opposite strategies. Some believe that we are headed into a deflationary depression, and these investors are hiding out in cash and long-term Treasury bonds. Others are very bullish on stocks, especially US stocks, arguing that the worst has been seen and that the world is recovering more strongly after the post-2008 recovery "flat-lined" in 2010/2011.

2012 has started out with a bang, as equity prices have jumped and held those gains, and most commodity prices have risen too. There seems to be a general sense of calming in the financial markets, as more investors seem to see slight improvements as precursors to a larger future trend of renewed growth.

Indeed, we at Kanos believe there is some relevance to this financial market strength. 2008/2009 has scared a number of business people around the world, causing them to err on the side of caution – lower headcounts, lower inventories, scaled-back capital expenditures, and higher cash levels characterize much of large US (and some world) industrial companies. At some point, companies will need to replace outmoded plant and equipment, put cash hoards to work, rebuild inventories and hire people – at least to replace retiring workers.

However, the sheer size of outstanding debts (even larger than in 2008, and more so on sovereign balance sheets) means that growth will be slower than other historical recoveries. Generally, the US economy should be creating lots of jobs at this point in the economic cycle, but growth is slow because of political uncertainty (even here in the US), continuing economic uncertainty and the inability to craft plans to lessen the worldwide debt loads.

Thus, the economic growth needed to grow our way out of our current debt load does not seem to be in the cards for 2012/2013. Many large developed countries have high debt-to-GDP ratios, with the US over 100% (not including Fannie Mae or Freddie Mac debt) and Germany over 83%. If one were to include all total debt (government, business and household), it is staggeringly large: as of 2009 (according to GlobalFinance.com), Japan led the way with total debt equal to 471% of its GDP, and the two largest developed economies, the US and Germany, had 296% and 285% total debt-to-GDP ratios, respectively. Asian growth engine South Korea even has a 333% total debt-to-GDP. These are 2009 numbers – **2011 numbers will be much higher** as deficit financing has ballooned public sector debt around the world. These large debts act as a brake on growth, as output is used to service these debt loads. And interest rates are near century lows, so the burden of interest payments is lower than in a normalized economic environment.

Dennis Gartman of The Gartman Letter put it into very good perspective, where he shrinks the US Government budget numbers so that we can better put them into perspective:

2011:	US Tax Revenue	$2,170,000,000,000	or $2.17 trillion
	Federal Spending	3,820,000,000,000	or ($3.82 trillion)
	New Debt in 2011	1,650,000,000,000	or ($1.65 trillion)
	Total National Debt	14,271,000,000,000	or $14.27 trillion
	Recent Budget Cuts	38,500,000,000	$38.5 **billion**

Taking off seven zeros to get it into a more recognizable scale and analogizing to a family budget produces:

Annual family income	$217,000
Money spent by family, annually	382,000
New Debt on credit line (credit card?)	165,000
Balance on credit line (credit card?)	1,427,100
Total budget cuts	3,850

This exercise helps to put the current economic situation into perspective for us. Almost $1.5 million of revolving/credit card debt, when one only earns $217,000 and spends almost $400,000 yearly, is clearly unsustainable.

We believe that this debt must eventually be paid off through a combination of growth, inflation and/or restructuring/default. The US, with federal debt of approximately $15 trillion and another $7+ trillion of Government Sponsored Entities (GSEs – like Fannie Mae and Freddie Mac) and large amounts of state and municipal debt on top of that, is going to have a hard time growing its way out of these debt levels. Slower growth European economies will have an even harder time. Thus, one or both of the other two debt reduction methodologies will have to be used over time – inflation is the traditional method, and restructuring or default is the messier and more draconian method. As debt levels have grown larger over time, their sheer size has dictated how they must be dealt with: inflation. In spite of Germany's reticence to expand European money supply, this is the only real method left to deal with such huge debt loads. Even in Germany, much of the engine of their past economic growth, exports to other European countries, will not continue in the future due to slowing/recessionary economic conditions. Therefore Germany is in the same boat as the rest of the European countries, just with more wealth and savings to draw on to postpone the inevitable.

Going Forward

We have been investing your capital with a bias toward conservatism while making sure we could benefit from the continued money printing by the world's central banks. The autumn/early winter of 2011 was characterized by lurches in financial markets, almost totally caused by news flow out of Europe. The LTRO loans by the ECB to European banks seem to have pulled the markets out of sheer panic, but these loans seem to have only solved the liquidity problem facing European banks – **not the solvency problem caused by their unwillingness or inability to recognize losses on their books, most notably in European sovereign debt**.

The need for European countries, especially Italy and the other PIIGS, to roll over their debts this spring will keep Europe as the touchstone for financial market moves. The December LTRO loans, while expected to be used to buy European sovereign bonds, are actually sitting on the ECB's balance sheet, not being deployed by European banks due to their need for liquidity. As European countries come to market for more and more debt issuance, we believe that the scheduled February LTRO will need to be very large to convince the market that there is enough further liquidity and that European monetary flows are not in jeopardy. Any further liquidity will lead to a lower euro and cause money to flow into hard assets, especially precious metals.

In the fourth quarter, we trimmed portfolio holdings for risk management purposes and to raise liquidity; this spring, we plan to redeploy some cash into attractive situations. If Asian countries can re-energize their economies and avoid too much more economic slowing (the proverbial "soft landing"), we would consider buying industrial and economically sensitive companies in coal, steel, energy, copper, machinery, shipping and materials sectors. If growth continues to slow, we will be looking at value situations in the energy, healthcare, agriculture and technology sectors. However, the situation is so muddled, we may be hedging, selling current positions, or even getting more concentrated if conditions dictate such moves.

Precious Metals Outlook

Our portfolios underperformed in the third and fourth quarters due to overweighted precious metals positions and particularly precious metal mining shares. However, in spite of the extreme negative price action in late September and again in mid-to-late December, a number of elements point to rising metals prices in 2012. They include:

1) Official central bank demand – a number of central banks continued their heavy buying of gold during the fourth quarter, providing a constant bid for large amounts of bullion. The Chinese central bank continues to buy Chinese mine production, while the Chinese government encourages its citizens to buy gold, who are doing so in size: gold imports into China through Hong Kong rose 20% in October to over 3.5 million oz, which is 483% growth year-over-year. The Russian Central Bank continues to buy much of its domestic production monthly, and announced it had purchased 300,000 more ounces in December, totaling over 3 million ounces for the year. The South Korean central bank bought its second large "chunk" of gold in November (almost 500,000 oz [over 15 metric tonnes]) to add to its reserves. So central banks with relative low percentages of gold in their reserve base continue to buy in size, supporting the price.

2) Negative real interest rates – already mentioned above, are key drivers for continuing investment demand. As cash investment returns are eaten away by inflation (even the "watered down" inflation as reported by government statistics), capital is encouraged to move to stores of value like gold (and silver) which are traditional, liquid, storable and accessible forms that should gain in value as more currency is created and rates stay artificially low. Fed Chairman Ben Bernanke has already stated that US overnight rates will stay near 0% through at least early 2013. Worsening economic conditions in Europe are putting pressure on the ECB (and the Bank of England) to lower rates closer to 0%. And of course, Japanese rates have hugged 0% for years. Thus, we believe this trend will continue to be a major driver of capital investment in precious metals.

3) Valuation of precious metals mining companies – with gold above $1,500/oz, most large miners are producing gold near (or below) $500/oz cash cost, yielding almost $1000/oz in gross profits. This has led to high net margins, averaging over 25% for the large North American miners. Additionally, mining companies trade around 11-22x trailing P/E ratios, 2x book value and generally pay a dividend between 1-2%. We believe the gold miners are very attractive as operating company investments and for long-term appreciation of their reserves in the ground. We also believe investors will be attracted to mining companies as value-oriented stocks with decent yields, while higher gold prices will allow growth through organic expansion or the acquisition of junior gold miners.

4) World gold mine production – only grew on the order of 5% for 2011 after rising only 3.7% in 2010. South Africa, the world leader in gold mine production until about 2005, has seen production fall for years, leaving it as only the fifth largest producer worldwide (after China, the US, Australia and

Russia). While mine production is expected to grow for the next couple of years, the mines are more remote with lower grades meaning supply is less sure than in past decades. Older mining districts, like South Africa, will see production dwindle while newer mining centers, like Canada, Mexico and Australia, will see production growth. We believe owning companies with large gold reserves in these politically preferable countries will allow us to realize even more value as the scarcity of recoverable ounces is revalued upward.

5) Market set-up – Like in 2008, gold prices in 2011 corrected significantly, taking out the 200-day moving average, but setting up for a powerful advance, buoyed by central bank money printing. We believe the December 29th low in gold probably marked the low for this cyclical correction, especially considering there was a large volume spike down that left what is called in technical analysis an "island reversal". This can be seen below in the circle on the chart of the SPDR Gold Trust (or the GLD) where it gapped lower on 12/29 on large volume and then gapped higher on 12/30. Many times such an "island" pattern shows capitulation, which can then lead to large price advances as weak holders have all sold out. Additionally, sentiment for the gold and gold mining sectors is very negative, which usually indicates that prices will rise in the near future as those who are negative have already sold. One final point: the LTROs of the ECB seem to be acting much like the Fed's first episode of quantitative easing in March 2009, i.e. lots of liquidity is needed to rescue the banking system, and some of that liquidity is invested in precious metals as a store of value. If future LTROs are very large, look for even larger advances in the gold price.

Energy Outlook

We at Kanos have been bullish on crude oil but have tried to avoid natural gas in our energy investments. This quarter proved the continuing trend supporting this strategy, and we will continue to try to avoid exposure to natural gas, which could be in a glut for at least two more years due to natural gas production which must be produced to get crude oil and natural gas liquids (which receive prices based on crude) out of the ground.

We have been pleasantly surprised at how well crude oil prices have held up in light of the resolution of hostilities in Libya and the rhetoric (but no action) around Iran/Straits of Hormuz and Nigeria. In recent years, oil has dropped in price during the month of January, but so far this year, crude has stayed strong, near $100/bbl, even in spite of recession fears in Europe and possibly other parts of the world.

As referenced above in the commentary, if 2012 is indeed similar to the 2008/2009, we may see a correction in the price of crude oil this winter. However, just like precious metals mentioned above, new discoveries are smaller and more expensive to find and develop. Finding enough new reserves worldwide to overcome the constant depletion of large fields is going to continue to be a supply problem which could buoy crude prices for a very long time.

Natural gas is a completely different animal. The shale "revolution" has caused a surplus of natural gas reminiscent of the 1980s' "gas bubble" – leaving North American gas supplies so plentiful to drive prices down to a level where producers are shutting off production rather than producing at a loss. Natural gas producers' losses are the economy's gain, as manufacturing and other large users of natural gas (like fertilizer producers) reap the benefits of low natural gas prices. Amazingly, there is still large and growing worldwide demand for natural gas (generally in the form of liquefied natural gas or LNG). This is especially true in eastern Asia and southern Europe, where LNG is priced on a crude oil equivalent basis. The shutdown of much of the Japanese nuclear industry along with the German nuclear plants will cause a permanent increase in demand for power, which will almost certainly require more natural gas to fuel new power generation plants. This should allow for expansion of LNG around the world, and may even allow for some natgas exports from North America! One limiting factor is the price to develop large export facilities since they require long-term export contracts. Energy companies will be hesitant to commit hundreds of millions of dollars to these facilities if they can realize higher prices concurrent with a recovery in US economic activity and a return to more normalized weather patterns; these factors will almost certainly make domestic supplies uneconomic for export.

Other Markets Outlook

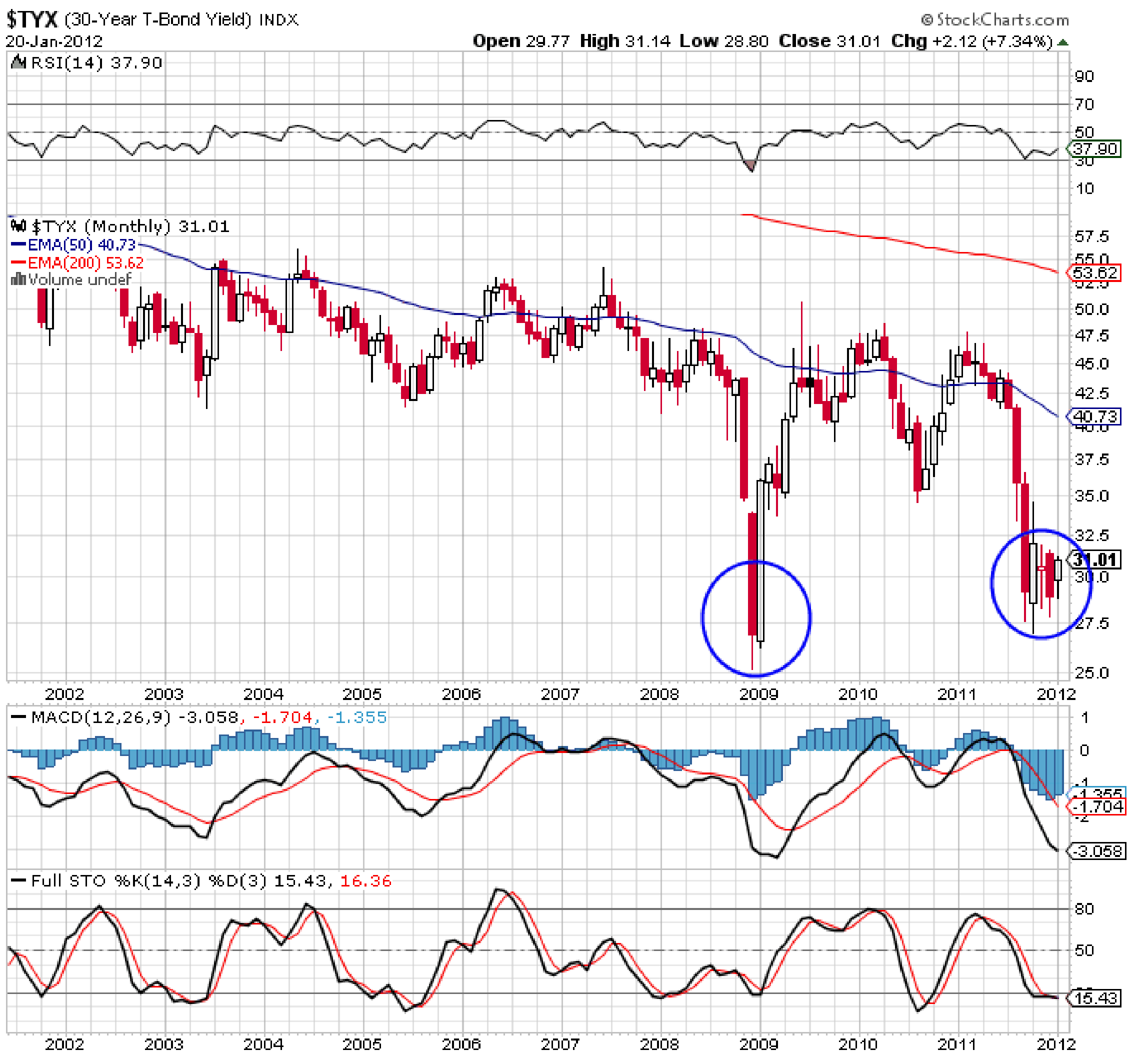
The two most interesting situations in the financial markets for 2012 are the prospects for the US equity markets and, especially, the US debt markets.

The US equity markets have started out 2012 with a bang as a slight improvement in US economic statistics have combined with attractive looking valuations and the removal of European politics/economics from the front page of every news and financial report (for the moment). The S&P 500 is trading at almost 14x 2011 earnings and near 12x 2012 expected earnings, both of which are on the lower end of P/E ratios for the past few years. However, the real question is whether those earnings will be realized. Profit margins are near historical highs at a time when many are worried about the ability for consumers to continue to support the economy, or whether the economy will slow markedly from its current sluggish pace. Meanwhile, the S&P earnings estimates are currently very dependent on a few large financial companies making large earnings gains: Bank of America by itself is responsible for 14% of total S&P 500 earnings gains (swinging from a $2.5 billion loss to almost $10 billion in profits); Apple with 5.3%, Goldman Sachs with 4.5%, General Electric with 2.3% and Wells Fargo with 2.2% are together expected to add another 15% of the total gains (courtesy ZeroHedge.com 1/4/2012). This shows the precarious nature of 2012 S&P 500 earnings and brings into question whether the market can stay at current levels. It seems like the market will end 2012 much higher or much lower, dependent on whether Europe can make some progress with its debt and political situations and whether the US can put to rest some of its political uncertainties and realize the estimated profits projected for the year for the S&P 500.

Long-term bonds, which performed very well for much of 2011, present a different set of issues. If the US economy is getting better, bonds will start to drop in price and rates will rise as demand for credit pushes rates higher. If the economy gets worse, the Fed will almost certainly join the ECB and Bank of Japan in cranking up more quantitative easing. This will hurt long-term rates as more dollars lead to inflationary pressure.

One motive driving recent buying of US Treasuries has been the move of capital from riskier areas (think Europe and the Arab world experiencing "Arab Spring" uprisings) to the US as a safe haven. This capital migration has accelerated as conditions in the European fiscal and banking arenas deteriorated during the fall of 2011. On the other side of the ledger and less publicized is **the selling of Treasuries** by some countries who think they have plenty of Treasuries and feel vulnerable with such low yields. According to the Treasury's November International Holdings data, **China's holding of US Treasuries is at a twelve month low and Russia's holdings have dropped almost 50% in the last year**, to only $80 billion.

The chart below shows the yield of the 30-Year Treasury Bond over the past 10 years. The two circles indicate times of very low historical yields. The first is the panic after the 2008 subprime/Lehman banking crisis, and the second is the US Government downgrade/ European fiscal and banking crisis. It looks to us like the yield has bottomed near 3%, as the risk/reward and rising inflationary pressures from quantitative easing or its equivalents around the world put a floor in long-term yields.



We continue to believe that owning a stock portfolio weighted toward natural resource companies and ETFs should make money during conditions of continued weak economic growth and easy monetary policies of central banks worldwide. We also like cheap stocks with attractive, long-established dividends, like pharmaceuticals and cheap materials stocks in agriculture and coal. We are less sure of large-cap stocks with questionable growth, lofty multiples and high expectations surrounding them (think Google, General Electric, IBM, etc.) and especially banks, whose earnings power seems to have been crimped by poor economic growth, narrowing credit spreads, and lower trading revenues.

We think US Treasuries offer a poor risk/reward trade-off at this point, although we do see the merit of owning corporate bonds or preferreds of companies in attractive industries in cases where income is of paramount importance. We are still concerned about the fragility of the US economy and the earnings which underpin the current levels in the stock market.

We have stayed in most of our portfolio positions anticipating further bouts of monetary easing; while easing indeed continued in the second half of 2011, we believe that further monetary easings will drive inflationary pressures that, in turn, will impact long-term interest rates. US stock markets will most likely have a positive year, albeit only on a nominal basis, as inflation continues to build.

The Managers of Kanos Capital Management