June 2009 Investor Letter

Second Quarter Market Conditions

The second quarter of 2009 was characterized by the ongoing rally in the stock market (that started in early March) which continued throughout much of the quarter. While the US economy continued to get worse, many in the financial markets were quick to argue that things were getting "less worse" (yes, you read that correctly), and thus the economy would soon actually be improving.

However, we believe that this is a classic bear market rally for a number of reasons. First, as we examine the rally, the stocks that have benefitted the most were 1) the severely "beaten down" stocks (banks, materials, consumer durables), and 2) stocks with the worst prospects, which had been heavily shorted. When traders realized that there were so many recently-established short positions in the market, they bought these stocks, driving up the prices. Second, volume for this bullish move has tended to be lower, showing a lack of institutional involvement. For this move to be the beginning of a bull market, large institutions would have to be involved. Third, as the rally gathered momentum through March and April, more and more portfolio managers felt the pressure to participate in the rally which added to buying momentum. As we have said a lot lately, one way portfolio managers at mutual funds and hedge funds can get fired is by not participating in a big rally. As this rally gathered "steam", more and more felt forced to participate; however, they generally concentrated purchases in "crowded" stocks – large cap technology stocks, large cap bank/investment bank stocks, some energy and materials (until mid-June, when they were sold relentlessly) and even housing stocks.
Fourth, while valuations are lower than in recent years, they were hardly at typical bear market "bottom" levels, even in March 2009. The S&P 500 ended the quarter with an estimated P/E ratio of 15.6x and a yield of 2.35%, hardly the "bargain" levels. And at the March 6th low, the P/E ratio of the S&P 500 was only about 11.7x with a yield of 3.2%, not particularly close to levels reached at a bottom, where P/E ratios generally reach 6-9x and yields are 5-7%.

What else caused the continued run-up in the second quarter? Two major influences should be referenced: 1) momentum/technical trading and 2) liquidity. As more and more traders bought into the rally, this momentum led to technical trading levels being reached, which then led to more buying. The most widely-followed technical indicator, the 200-day moving average (of the S&P 500, in this case) was at 919 when the S&P 500

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surpassed that level in early June, bringing in more buying due to the bullish tendency of prices to rise when they surpass their 200-day moving averages. Second, with the amount of Federal Reserve (Fed) monetary stimulus in the economy, coupled with the fiscal stimulus being put forth by the US Government, some of those dollars found themselves being put to work in the financial markets, and in the stock market. And with money printing and fiscal stimulus occurring around the world, foreign money was placed in the US stock markets, as well as stock markets around the world, as investors and traders decided that the worst "might" be over, and that money could be invested in risk assets once more.

We have been a little more sanguine than many investors as we will talk about throughout this letter. We at Kanos believe that there are a number of problems still exist in the US (and world) economies and in the financial markets that must be worked out before the next bull market will be sustainable. Thus, we were surprised by the continued strength of the move upward, and we continue to eye it suspiciously.

We do still believe that our thesis over the last couple of years is still compelling: easy money policies of the Federal Reserve, coupled with deteriorating fiscal condition of the US Government (but which continues to produce more fiscal stimulus, worsening its financial position) will lead to a devalued dollar and inflation, from which we will try to protect ourselves by investing in things that will hold value in that environment: dollar-denominated commodities and commodity producers, foreign currency ETFs, select common stocks with pricing power and cash (on a short-term basis). We feel so strongly about the possibility of future rising inflation and the impacts of current deflationary forces that we have included a separate Q&A about inflation in this packet.

Precious Metals

Gold, after rallying up to $1,000/oz in February and then backing off, went on a rollercoaster ride during the quarter. April was a "down" month, May was a big "up" month, and then June was another "down" month. Silver, generally more volatile than gold, performed roughly in-line with gold, but did not reach concurrently high prices when compared to gold. Platinum and palladium performed better, but from much lower starting points. The real story for these metals was that while they were weaker, they did not trade below technical support levels (holding above their 200-day moving averages) during the early summer months, which are almost always seasonally weak for jewelry demand (post wedding season and pre Christmas season). As confidence in a worldwide economic bottoming and rebound gathers momentum, we believe that inflation forces will drive gold far above the $1,000/oz level. However, in the interim, we are fearful of a selloff in the US (and world) stock markets, which in the last year has also caused precious metals prices to fall as traders sell metals to supply cash lost in riskier stock market trades.

Precious metals stocks performed worse than the actual metals prices in June after very strong performances in May as traders fretted that deflationary forces may cap future gains in metals pricing. We continue to believe that the market is underpricing these stocks, even when fully risk adjusted, because many of their costs are still falling while their pricing, while seasonally weak, is still very strong when compared to historical prices.

Energy

Oil prices continued their climb which started mid-winter, moving from just over $50/bbl in late March to around $73/bbl in mid-June before closing June near $70/bbl. Energy equities were some of the market leaders during much of the quarter but gave back some of their gains in late June as traders became concerned about deflationary forces. Natural gas unfortunately was not as bullish, with prices falling in April, recovering in May, but falling through most of June. Continued slack demand (most of the country had the coldest June in decades, although Houston had one of its three hottest ever) for power to serve air conditioning "load" and ever-slowing industrial demand (think closed auto factories and steel mills) meant that ample supplies filled storage and led to continued low prices. However, we believe the current surplus of current production and high storage levels of both crude oil and natural gas will change in the future to falling deliverability and dwindling storage as underinvestment in the past few months causes tighter energy supplies and higher prices. Oversupply is a longer term problem for natural gas due to huge potential deliverability from US shale gas and world LNG supplies, meaning it will take longer to work off excess deliverability in the natgas arena.

Commentary

"Patience: One of the Hardest Concepts in Investing, and Why Aren't We Out of This Bear Market Yet?"

Patience.

In the investment world, patience is one of the simplest concepts to understand but very difficult to master. Why is this important? On a micro and macro level, we are seeing a lot of "back-and-forth" action, indicating a large amount of disagreement about what is occurring in the worlds' economies, financial systems and financial markets. We read an awful lot about the US economy, world trade, financial flows, costs of funds and prices of various commodities and products. What we have found is large disagreement about the future – from inflation to deflation, from depression to a new powerful bull market in a recovering economy, etc. The financial writers we follow regularly are split about when and how much of an economic recovery we are going to have.

With this uncertainty we believe one of the best things to do is **<u>have patience</u>** until things begin to resolve themselves. Since it has been difficult to understand financial market reactions lately, we have been patient – making sure our current portfolio positions are sound, minimizing our additional position-taking and keeping most new funds received in cash. While this is frustrating, we believe that waiting to commit our funds will ultimately prove to be less painful than trying to jump into positions that we may have to sell due to market weakness (we find it is harder to make two good decisions than one). As Arthur Cashin of UBS Financial Services said lately, "it's [usually] the second mouse that gets the cheese."

This quarter we've decided to switch to a question and answer format in order to allow you to better get a handle on issues you may want to ask about your portfolio but have not had a chance to do so. So we at Kanos have proposed a bunch of questions that we have answered. Hopefully, this will be a format which allows you to better understand our philosophy and portfolio management, and also may lead to some questions which you may want to send to us or ask us directly.

Q: How can you tell when we are out of the bear market?

A: Bear markets usually end in a whimper, when selling has been exhausted. Bull markets then form as buyers slowly emerge, and the residual selling has been satisfied. People rarely call "the turn" to a true bull market, because many former market participants are no longer interested in the markets or they have shifted their money away. A good example of "classic" bear market rallies are shown below in a chart of the Shanghai Stock Market during the early 2000s:

This chart shows China's Shanghai stock market from 1999 through mid-2006. After hitting a new high above 2200 in mid-2001, the stock index fell 50% in early 2002, rallied three times from 2002 to early 2004 with the "bottom" always holding around the 1300 level. But these three rallies were "bear market rallies" that eventually gave way to a bottom in mid-2005, more than 4 years after the highs were reached. The 2001 high above 2200 was not surpassed until early 2007 (not pictured).

Q: What indicators can we look at to see whether the bear market has ended?

A: There are a number of things that would point toward a "classic" end of the bear market. They include: 1) improving economic fundamentals, 2) very low P/E ratios for stocks, 3) high dividend yields, 4) rising volume (often from a low initial level) and 5) economic barometers, like bank stocks, leading the market on a day-in, day-out basis.

Q: Which is the most important?

A: Having a healthy financial system is very important. I have a hard time believing that we can recover as we have from other downturns with massive government subsidies in the banking system. Large banks have received government cash infusions, expanded government deposit guarantees and government backing to guarantee bonds issued by the banks. While some banks have now paid back their "TARP money", the government is still supporting much of the banking/financial system with 1) TARP money in small &

regional banks, 2) guarantees in money market funds, 3) increased deposit guarantees and 4) increased governmental/central bank monetary stimulus (Fannie/Freddie expansions and the Fed's buying of 1.5 trillion in debt).

Q: Why is this such a problem?

A: In the past few recessions, the Fed has lowered short-term interest rates, allowing banks to borrow very cheaply and lend at higher rates over longer periods, and "earn the interest rate spread". However, the "stress tests" for large banks conducted this past winter/spring revealed that a number of these large banks needed more capital to weather stresses that could be caused by a further weakening economy. A number of large banks raised money in the bond market without the government guarantee. However, the rates were very high (Citigroup raised $2 billion of 10-year notes on May 15th yielding 8.8%) which is not encouraging toward future "cheap" lending to bolster economic growth.

Q: Isn't Citigroup the "worst of the bunch"?

A: Yes, but they are also the biggest (or were). Bank of America raised $3 billion of non-guaranteed 5-year notes at 7.375% and Morgan Stanley sold 10-year notes paying 7.3%. This is expensive money that is just allowing these large banks to maintain their current asset (loan) levels, with no room for increased lending like the US government is encouraging. The real question is the regional banks.

Q: Please explain.

A: The regional banks, except for the very large ones, did not get involved with the more complicated lending products and derivative products on nearly the scale of the large banks. Thus, their businesses in the last few years were centered on commercial real estate lending, construction loans, residential mortgages and business loans. These loans have not had to be marked-to-market (bank loans were never subject to frequent valuation) and these regional banks were not stress tested. But those loans are starting to show growing delinquency rates, eroding regional banks' already depleted capital, crimping their ability to lend in the future.

Q: Where does housing figure into this?

A: Housing is so important because: 1) so many people's principal savings/investment vehicle was their house (or their second home), so preserving value is important and 2) housing provided so many jobs in the US economy; thus, overbuilding and falling demand/prices has deprived people of their wealth and robbed the economy of a huge number of jobs (construction workers, raw material company workers, real estate agents, finance professionals, etc.).

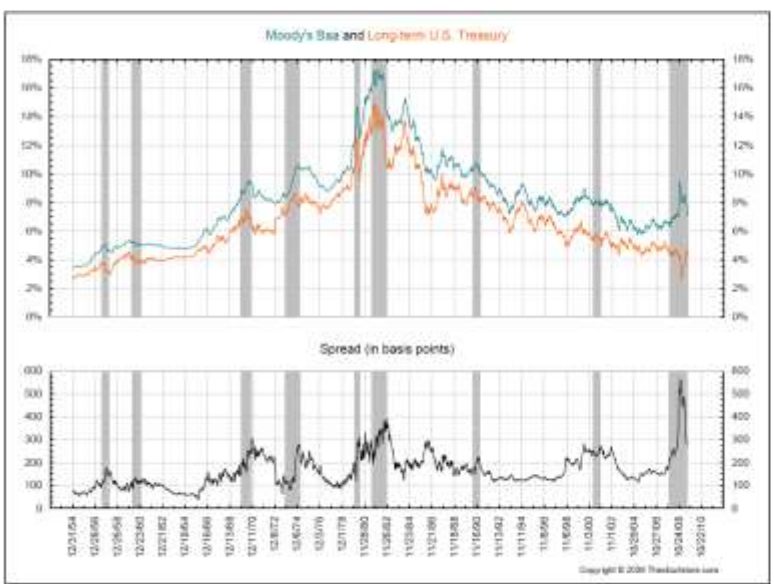
Q: Have we seen the worst in housing?

A: While housing prices have corrected between 20 – 40% in many areas, in most cases that takes us back to prices just before the housing boom. Since prices often "over-correct" after rising so far above the average, we believe there is still more downside. This notion is supplemented by the fact that many of the variable rate loans which were re-negotiated in the past two years will have interest rates that re-adjust upward during the next eighteen months, meaning many people's mortgage costs will rise substantially, most probably leading to more foreclosures, which will contribute to further downward pressure on housing prices for many months to come.

Q: Throughout most of the spring, longer-term bond rates rose; you believe this will cause problems for stocks. Can you explain more about that?

A: We believe two major forces will take interest rates higher in the near future: 1) the falling value of the US dollar caused by excess dollar creation and falling international confidence in US fiscal prospects, and 2) continued high risk premiums. This huge creation of money that the Fed has produced over the past few months will push down the US dollar, causing commodity prices to rise and igniting inflation. Meanwhile, the US Government will be selling increasingly large amounts of government debt. These two factors will make all borrowing, whether corporate, municipal or real estate, more expensive, since most debt is priced at a differential to US Treasury rates.

The chart below shows the spread between Treasuries and medium-risk corporate bonds is still (after a huge drop) near the highest previous record spread, meaning corporates are still at extremely high interest rates. Treasuries are being "artificially" kept lower in yield by Federal Reserve buying, done to try to keep long-term mortgages rates low.



Q: How about the economy?

A: The economy appears to have bottomed out according to a number of Wall Street analysts. The problem with the economy is that it will have a hard time building growth from this point because of consumer debt-servicing loads, rising savings rates (meaning less consumption), rising unemployment rates, and limited availability of bank loans. However, businesses appear to have liquidated inventories throughout the downturn last fall, so there should be some at least temporary growth as businesses build back their inventories. But what are the engines of job growth that will replace jobs lost in the financial services (mortgages especially but also consumer finance, etc.), automobile manufacturing and distribution, and other hard hit industries? Some claim there will be new jobs from "green energy"; however, the growth of government-subsidized alternative energy programs will almost certainly cost jobs from traditional energy companies, meaning there will probably be a net job loss from the governmental alternative energy "push". We have a hard time coming up with industries that will produce job growth in large numbers going forward

Q: How will earnings turn out going forward? Is that part of your concern?

A: 1) Higher interest rates, 2) increased taxation, 3) decreased pricing power (due to low demand and low capacity utilization), 4) continued high raw materials costs, and 5) lack of any significant technological innovations are all going to contribute to pressure on US corporate earnings going forward.

Q: What taxes are going to affect profits and the economy?

A: President Obama and House Democrats have crafted a number of bills that will end up raising taxes, at least for the wealthy. The most serious is the "energy tax" or "cap-and-trade" system where the costs of emissions from the energy industry and other heavy industries will be added to the prices for that energy for energy consumed in this nation. The proposed health care bill is crafted to be paid for a surtax on highly-compensated people in our economy. The Democrats have also targeted a large amount of corporate tax provisions that they want to change so that more tax is paid, making some US corporate tax provisions more

Q: The US House of Representatives just past a cap-and-trade bill; assuming the Democratic-controlled Senate also passes a version, what do you think will be the effects from this legislation?

A: Cap-and-trade, if instituted, will cause industries that emit carbon dioxide to pay for credits to cover their emissions. These costs will be passed on directly to energy consumers, meaning electricity rates, gasoline and diesel fuels costs, costs of plastics and other petrochemicals will all be more expensive. And this will affect all US residents who use energy, regardless of their economic situation. And at least initially, many of these credits will be given away, so this law will include income redistribution (some will sell credits they received for free, getting the benefit of these "taxes" personally) and cause renewable energy, much of which is not economic at current energy prices, to be more expensive but made economic by cap-and-trade subsidies passed to these companies.

Q: So what is the real problem?

A: We have a real problem with some big picture items:

1) Can the Fed and US Government really just create/spend $5–10 trillion in stimulus and government support (plus all the international stimulus packages) and be out of this whole economic downturn?
2) The market basically rallied from 1982 to 2007, so have we really corrected from that 25-year rally in just 18 months (the October 2007 high to the March 2009 low)?
3) Lots of companies beat earnings expectations this summer, which is a big part of why we have had this rally. But revenue at many large companies has been sequentially falling from 4Q2008 to 1Q2009 to 2Q2009, meaning cost cutting and expense control have been the drivers for companies' earnings. But can we have a real recovery with continually falling revenues?

These are the things that bug us, and we think they will start to bug investors more and more as gains from cost cutting run their course. That should lead to a correction in the market, especially in the high valuation stocks where the growth in revenue that people anticipate just never seems to materialize, although earnings expectations may be met by continued cost cutting and accounting games.

Q: What about oil – demand and supply?

A: Demand is obviously down, although it is down less than many think. Gasoline demand has dropped since last summer, but in May, miles-traveled in 2009 were slightly higher than comparable May 2008 amounts. US gasoline usage as reported by the US Energy Information Agency in 2009 is less than 1% below comparable levels for the first half of 2008. Worldwide, energy demand is expected to grow fractionally during the second half of 2009 after dropping last fall and winter. Supply is the harder factor to figure out. Opec is thought to have up to 4 million barrels per day of excess crude oil deliverability, but much of the world's incremental supply capacity over the past five years has been heavy (thicker) sour (contains too much sulfur which must be refined away) crude which is more difficult and expensive to transport and refine. In addition, the violent downward movement of crude last fall/winter has caused a number of projects to be cancelled, and while a few have been reinstated with expectations of crude staying over $50/barrel, large incremental supplies will not appear in the market for many years at current price levels for crude oil.

Q: $50 per barrel of crude oil seems like a very high level compared to just a few years ago. How come more oil won't be brought to production at such price levels?

A: Large discoveries of crude oil were common place in the 1930s – the 1960s, but the world hasn't discovered much oil (in aggregate) in the past two decades, so the oil that was brought online up through the 1980s was found years before and was generally easy and inexpensive to produce. Since then, new discoveries have occurred in more remote areas, offshore less inhabited areas (Angola, Equatorial Guinea, Sakhalin Island, offshore Eastern Canada, etc.) and in expensive unconditional forms (tar sands in Canada and Venezuela, oil shale, etc.). These new discoveries have "all-in" costs that range from $50 – 75 per barrel, as opposed to conventional discoveries that had all-in costs of $2 – 20 per barrel. Contributing to higher costs of new discoveries is the higher costs of oil field technology, which requires higher tolerances (all equipment has to be larger and thicker to serve in deepwater or arctic climates), meaning services and materials cost more than twenty to forty years ago. We are also facing a need to replace much of our older oil infrastructure and worker population – many experienced workers are retiring and lots of older equipment needs replacing before it fails (remember BP's Prudhoe Bay, Alaska pipeline corrosion problems?). Finally, as crazy as it sounds, it requires more energy to find oil than it used to – so our "energy intensity" is rising; we use more energy to find what we need for our use. This further drives up prices.

Q: Hasn't technology always allowed us to find more energy more cheaply? Why is it different today?

A: Technology is being used to cut finding costs; it is no different today than before. The difference is that the locations where the world is finding large concentrations of crude oil is farther away and in harsher climates; thus, without constant technological innovation, we would have even higher costs for finding and producing crude oil today.

Q: Before we leave energy, what about natural gas?

A: Natural gas production was revolutionized over the past few years when fracturing techniques coupled with horizontal drilling allowed companies to drill natural gas wells in shale beds and extract large amounts of gas systematically. The Barnett Shale around Fort Worth, Texas was where these techniques were perfected, and these techniques have been adapted for use in large shale areas of northern Louisiana (Haynesville Shale), Oklahoma (Woodford Shale), Arkansas, Appalachia (the Marcellus Shale in Pennsylvania, West Virginia and a number of other states) and even British Columbia (Horn River Basin). These areas are expected to be able to produce large quantities of gas quickly (high deliverability, short-lived wells) that have sent natural gas prices to multi-year lows. Large amounts of liquefied natural gas (LNG) is starting to come on around the world (Qatar, Indonesia, Russia, Australia, etc.) which had been slated for Asia and Europe but

Q: What about gold?

A: Gold has stayed in the $900s per oz. throughout the spring in spite of falling jewelry demand and reduced wedding demands from India, both suffering from the high price. Gold has been supported by investment demand as investors react to geopolitical instability as well as large amounts of monetary stimulus being administered around the world by central banks. Meanwhile supply is starting to wane as mines are harder, more costly and more expensive to bring online. Newcrest Mining, Australia's largest independent gold miner, just reported a decline of 8.6% in gold output, in spite of high prices, as some of their mines weren't able to keep up with current production rates. South African gold output has been dropping since 2000, with SA falling to third largest producer from being the largest producer for decades. Thus, supply of gold may start to be a concern as 2009 progresses.

Thoughts for the Future

We have probably painted a bleaker picture than you may have thought having watched the recent upward market action, but we are trying to bring as much reason to the process of investing your money and trying to block out as much of the emotion possible. Our job seems a lot easier when stocks are going up – it makes investors feel good, and it reminds us that if we have truly hit bottom, then better times must be ahead.

But in investing your money, we have tried to always keep an important concept in mind: what is the downside of our investments? At times in the recent past, we have judged conditions good enough to have virtually all our funds invested in stocks, while at other times, we feel there is more risk than reward. We have also found out (quite painfully last year), that things can change very quickly, and that our investments can suffer significant losses even in the face of apparently attractive fundamentals. So our recent reticence for increased investing lately is because we can see a number of issues that could impact the market in a similar fashion to the way we saw the financials react from 2007 – 2009.

General Stock Market

As we said above, we feel that US companies have a number of factors that will hold back growing their earnings in the near-to-medium term. Thus, while we frequently look to see how a number of sectors are doing, we still have a hard time "pulling the trigger" on buying stocks of companies and industries that we believe have tough revenue growth challenges, little more expense reductions to take, and increasing worldwide competition for their products. However, we still look at other commodity industries (coal, agriculturals, base metals, timber, etc.), pharmaceutical and healthcare companies, small financial companies, and a number of industrials. We also look overseas at a number of markets and large companies in Canadian, Latin American, Asian and European markets. We hope to be putting money to work in these other sectors and countries, but we still believe that we will have a more attractive entry point sometime in the future, and we don't want to overpay now and be sorry that we are sporting losses when, with patience, we think we can truly buy at bargain valuations.

Precious Metals

The large amount of central bank-created reserves is starting to affect investors' anxiety level over the level of paper currencies, and the precious metals have bottomed since their horrible performance in June. We believe we will continue to see a lot of back-and-forth price action below $1,000/oz in gold (current prices are just above $950/oz), but believe that we will see $1,200/oz some time during the fall as more money is created around the world and gold demand increases seasonally. Silver, the more volatile of silver and gold, could trade back up to $20/oz from its current $13+/oz level if gold breaks out. Platinum is harder to get a grip on since it is so linked to automotive sales due to is use in catalytic converters.

What is the downside in metals? Each could probably re-trace to their 200-day moving averages, which would be currently around $880/oz for gold and approximately $12.30 for silver. These levels were not reached when prices recently fell, so the risk/reward seems to be in our favor

Energy

Energy prices continue to be quite product-specific. Crude oil seems to have found a range from the high $50s/bbl to the low $70s/bbl, with mid-to-high $60s/bbl where we are currently. We believe this has the potential to be in the $70s/bbl and maybe as high as the low-$80s/bbl if Asian and Latin American economies continue to recover. Crude oil exploration projects have continued to be postponed and cancelled in light of lower prices and higher price volatility.

Natural gas, while seemingly stabilizing in the mid $3/MMBtu, have a number of headwinds before the winter and even after it: high production rates for new shale-gas wells, rapidly-filling storage facilities, meaning pre-winter surpluses could drive down prices due to gluts of deliverability, and longer-term: high and rising prospects for domestic shale gas deliverability over the next few years coupled with a number of large LNG projects coming on line this fall and more next spring; unless European and Asian demand for these increased LNG supplies picks up dramatically, the LNG could end up in the US, continuing to depress prices for 2010 and beyond.

Coal, still seemingly abundant throughout the US and the world, is facing environmental assaults, meaning expanding market share for coal in the US is going to be difficult. Thus, domestic prices will probably mirror natural gas prices in many markets, since gas and coal will compete more and more in the future for electric generation and heating. Coal is the obvious fuel choice for electric generation throughout the rest of the world, and developing economies find the economics of coal-powered generation too attractive to pass up, in spite of the environmental protests and downsides. Thus, we believe demand for coal worldwide will keep a bid under coal, and domestic coal stocks will probably perform worse than international coal producers.

Currencies

We have done some investing in Exchange Traded Funds (ETFs) that invest in foreign currencies. These ETFs use financial instruments to provide us with a typical return (both income and appreciation/depreciation) from an investment in short-term bonds in those currencies. We are currently attracted to the Canadian Dollar ETF, Australian Dollar ETF and being short the Japanese Yen through an ETF. We see the non-US dollars performing well due to their resource-based economies that have held up through the economic crash of the last year. The Japanese Yen is far too “strong” for Japan’s export industries to re-start their growth, so we believe that the Yen must depreciate (possibly with government intervention), meaning we would profit as the Yen falls in value.

We continue to monitor the financial markets for attractive investments, and we will try to keep a balance in risk and reward while trying to build wealth through appreciation and income.

Inflation vs. Deflation

The “winner” of this battle of economic forces will go along way toward defining our economic future. For that reason, we have broken out this section and included with it a gift for you to see what hyperinflation would look like. Hyperinflation, no matter how much you hear about it, is extremely rare and its probability of occurring is very low. But it is worth thinking about.

So on to the debate:

Q: Inflation or deflation – which is going to happen and why?

A: There are forces traditionally associated with inflation and forces of deflation currently impacting the world’s economies. The financial markets seem to “flip-flop” every couple of months on which force will “win”.

Q: What deflationary forces exist currently?

A: Souring debts, falling asset and real estate prices, rising unemployment and falling factory capacity utilization are some deflationary forces. These all prevent cash from going into more productive uses in the economy. Deflation is often defined as "too little money chasing too many goods"; in these cases, souring debts and asset prices rob individuals of wealth, unemployment takes away the ability for individuals to earn cash and spend it, falling capacity utilization means less pricing power because competitors have the ability to undercut each others' prices, causing prices to fall.

Q: What are some inflationary forces, and do you think they'll "win out" over deflation?

A: The most potent inflationary forces are ultra-low interest rates and money creation by central banks. Very low interest rates allow more capital to be bought/put to use per dollar of interest cost, creating larger buying power. Money creation (often referred to as "money printing") puts more dollars (or euros or yen or yuan, etc.) into an economy which (all other things being equal) means prices should move up; why? Inflation is often defined as "too much money chasing too few goods". Since central banks have the ability to create money essentially for no cost, and there are still large deflationary forces impacting world economies (as referred to above), the Fed Chairman, Ben Bernanke, has said repeatedly that the Fed (and other central banks around the world have parroted his views) will create money to ward off deflationary forces until the Fed is sure that the financial and economic crises have ended. And Bernanke has stated definitively that monetary stimulus will be kept "in the financial system" until success at ending the economic crisis is assured. To us at Kanos, this means that rates will be low and money plentiful until inflation is inevitable.

Q: What is the downside of inflation?

A: Inflation means that prices of things rise, and as long as incomes keep up, then the effect on individuals is less easy to determine. But for people on fixed incomes for living or people who are saving money, inflation erodes their purchasing power, as costs go up, but their incomes don't. If inflation were to get out of control and prices were to keep rising, than hyperinflation could occur. It has occurred in Weimar Germany in the 1920s, at times in Latin America over the last few decades, and most recently in Zimbabwe – currently. I have presented you with a $100 trillion Zimbabwe dollar bill to show you an extreme case – that's $100,000,000,000,000!

Q: What are the current indicators helping determine whether we will see inflation or deflation?

A: The indicators most watched by market participants are government and Federal Reserve inflation/deflation numbers. The most widely broadcast are the Producer Price Index (PPI) and the Consumer Price Index (CPI), the latter of which is used to adjust incomes for people entitled to "cost-of-living increases". There are a number of market participants that believe the CPI understates actual inflation because it incorporates adjustments that depress inflation because of higher efficiency of technology and machines (i.e. you're paying more, but you're getting more, so they adjust the price down to reflect better "productivity").

Q: What does the CPI, the most watched measure, say about inflation/deflation lately?

A: Jim Grant, long-time financial writer who publishes Grant's Interest Rate Observer, recently (6/26/09) wrote about inflation measures during this downturn versus others, most notably during the Great Depression. After referencing that the CPI fell 1.3% during May 2009, he notes: "It's a funny deflation, though. Deflation, to us, is too much debt chasing too little income. One symptom of deflation is falling prices. In a proper deflation, prices fall broadly, not narrowly. ***Seventeen months into the Great Depression, the CPI had fallen by a cumulative 8.1%. This time around, December 2007 to date, it's risen by 1.8%." [Emphasis our – Kanos]*** Thus, it looks like, even though many raw material prices are far off their highs, inflation has cumulatively continued to rise, albeit including some months with some significant deflationary readings. On a more anecdotal level, even with excess capacity, diverse companies like Kimberly Clark's Kleenex division, Kellogg's cereal division and AK Steel's Ohio steel company have all announced price **<u>increases</u>** almost 1 ½ years into a bad recession/mild depression, and by all accounts, it looks like these increases will stick. Can deflation really take hold as long as the Fed and the US Government continue to stimulate with such large sums of dollars?

The Managers of Kanos Capital Management

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