Second Quarter 2011 Investor Letter

In general, we at Kanos believe the US stock market this spring has been priced to reflect growth at a rate slightly less than a typical post-war recession. However, two major aspects of this valuation bear more scrutiny: interest rates and corporate profit margins. US companies are valued very highly because they have been able to borrow at historically-cheap interest rates and their profit margins are near all-time highs. These are conditions which generally cannot get much better, i.e. stocks seem to be priced for near perfection. Why are profit margins so high? Slowly rising inflation has allowed many companies (food companies, insurance companies, health care companies, energy companies, etc.) to raise prices, citing higher costs. Yet, in many cases, costs have been contained through lower wage growth (either through layoffs or postponing new hiring) and lower financing rates. Higher raw materials costs and wage cost pressure will hurt profit margins in the future. Inflation caused by easy Federal Reserve monetary policy and higher overseas rates will eventually cause longer-term interest rates to rise, making financing more expensive. And of course, high unemployment and continued depressed housing prices will eventually limit consumers' ability to afford price increases on anything but essentials, driving down demand for discretionary items and hurting profit margins by dropping demand for goods. We mention these factors to convey our pessimism toward the US stock prices for many sectors, because falling profit margins, higher financing costs and slowing sales will mean that the real underpinning of the current "reasonable valuation" arguments, future earnings, are at risk and with them, valuations and stock prices associated with emergence from a recession. Thus, we have continued to try to concentrate on industries where we think there is pricing power: precious metals, energy, pharmaceuticals and others so as to limit our exposure to companies that have and may exhibit more negative earnings surprises, like some technology, consumer discretionary and even industrial stocks. We would like to see the Federal Reserve stop increasing money supply and the US Government to spend far less and to actually reduce US Government debt – we believe that monetary and fiscal soundness could go a long way toward creating a much more attractive investment environment.

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Second Quarter Market Conditions

The second quarter ended up being another "rollercoaster" for the financial markets as large macroeconomic cross-currents drove up and drove down financial assets of all types at various times during this timeframe.

Ultimately, the angst over the end of the Fed's QE2 program and the continuing deterioration of European fiscal conditions led to worldwide investors moving to the US dollar and US assets (especially equities), putting downward pressure on commodities and non-US stocks, which make up the majority of our portfolios.

Most surprising was the disdain for precious metals equities, futures and ETFs in the face of rising worldwide concerns about still-out-of-control spending by developed countries' governments, continued rising inflation and civil unrest in regions around the world. However, investor "certainty" that: 1) the US debt ceiling/fiscal austerity talks going on in the US Congress (and with the Obama Administration) would yield constructive results, 2) the Federal Reserve would apply "just enough" monetary stimulus to help growth but retard inflationary expectations, 3) European leaders would be able to continue to craft "aid packages" with the International Monetary Fund (IMF) and the European Central Bank (ECB) to allow struggling European countries to stabilize enough to grow themselves out of their financial straitjackets and 4) US states would be able to mitigate their fiscal woes with minimal pain, would all happen allowed market participants stay in overvalued stocks and bonds, ignoring the safe haven aspect of precious metals. Couple these "dreams" with nuclear power concerns at a few places around the world [Japan's meltdowns and concern in the US due to flooding of nuclear power plants] plus the continuation of unrest in spots in the Arab world….and precious metals would seem primed for another strong run to the upside. However, in the 2nd quarter of 2011, such an advance for metals was not sustainable beyond April.

April was an "up" month for the financial markets as all sectors and asset classes advanced late in the month after a mid-month swoon. After the weakness caused by the earthquake/tsunami of mid-March was overcome, industrials and consumer stocks (both durables and staples) led the way during the month. The standout was healthcare, as dividend-paying healthcare stocks were snapped up by investors and traders, leading the S&P 500 to a yearly high at the end of April. Silver led the way in commodities, moving higher almost daily to reach just under $50/oz (the 1980 "Hunt silver corner" high), but failed to breach that level. Gold followed silver and reached an all-time high around $1,570/oz by the end of the month. Energy commodities also climbed to yearly highs as the world economy was judged to be weathering the post-Japan disaster weakness and its repercussions. Gasoline led the way higher in energy, pushing average retail prices over $4.00/gallon nationwide, and Brent crude traded as high as $125/bbl. Bonds, after selling off early in the month, also ended the month higher, as large numbers of investors chose the yield and safety of US Treasuries over the volatility of many other financial markets.

May made April look like child's play, as volatility rocked nearly every financial market. Silver crashed during the first week of May, falling more than 30% in a week and pulling down the markets with it. The S&P 500 had its worst month in 9 months, losing more than 1.1% in spite of a late May run higher. Energy, financial and technology, the three leaders to the upside since last August, were the three weakest price performers, while the consumer staples, healthcare, utilities and telecom were the winners during May. In spite of poor commodities performances, precious metals stocks had only small losses for the month, showing that the bull market for metals is intact. Energy commodity prices were pulled lower by the silver crash, and West Texas Intermediate (WTI) crude oil prices fell from $115/bbl to around $100/bbl for much of May. Gasoline, the outperformer in April, was also strongly lower in price, led by fears of demand destruction. Some of the price action was due to a bounce in the US dollar, as traders short the dollar were forced to cover their trades; the euro, which had reached $1.495 at the end of April, dropped in May below $1.40, settling around $1.42/€ by the end of May.

June was a replay of May in many respects, with equity prices dropping for the first eight business days of the month. Despite this weakness, a late month run allowed the US equity markets to recover some of the losses, allowing the S&P 500 to finish the quarter virtually flat. All sectors were down for the month, with consumer staples, financials, technology and energy were the big losers while materials, utilities and consumer durables (led by a [dubious] rebound in US auto stocks as Japanese car part production resumed [at a 30% reduced rate from pre-earthquake levels]) were down the least. Gold was down $40 to $1500 and silver was down $3 to just under $35 during the month, as investors moved into US cash and US bonds instead of hard assets during June. The continuing deterioration of economic statistics took a toll on energy prices during the month, as oil prices dropped on world demand concerns. WTI crude futures dropped from over $100/barrel to as low as $91/bbl during the month before recovering to almost $96/bbl. Natural gas continued its dismal performance by dropping 10% from $4.80/MMBtu to under $4.40/MMBtu in spite of extreme hot weather over much of the US during June. Bonds rallied during much of June, but even bonds suffered by the end of the month, as the end of the Fed's QE2 bond-buying program impacted price expectations going forward. The yen and euro oscillated around 80 yen/$ and $1.42-44/€ for most of the month.

Precious Metals

As mentioned above, precious metals were led by the strength in silver in April – reaching the high $40s/oz late in the month and pulling up gold, platinum and palladium prices to yearly highs by the end of the month. Silver garnered huge participation, especially from hedge funds and the speculating public, driving up trading volumes to highs not seen since the 1980s. However, silver was overextended and crashed at the beginning of May, caused in part by huge margin increases for futures markets participants (and a large at-the-market sell order on an illiquid Sunday night, May 2nd that precipitated the selling), going from $49/oz to $32/oz in a week. Gold held up much

better, dropping from $1570/oz at the end of April to the $1480s before stabilizing and moving back above $1530/oz by the end of May. June was more of a slow burn, with both metals bobbing between their recent highs and lows but ending the quarter on the lower side of their ranges. The price movements from mid-May to the end of June reminded me of what octogenarian money manager/financial commentator Richard Russell describes as resembling "a balloon held under water" – prices of precious metals can stay down for awhile, but the economic forces act with the same style as the force of water on a balloon: eventually, the balloon is forced up by all the force exerted on it. Russell (and we at Kanos) feel that the easy monetary policy/fear/store-of-value forces will come to bear on the precious metals in the third quarter, pushing gold (and possibly silver) to new all-time highs.

Energy

Crude oil continued gains from the first quarter, as continued strength of worldwide demand and continued supply concerns pushed crude to yearly highs of near $115/bbl for WTI and above $125/bbl for Brent and other light crudes around the world. Gasoline was the standout, pushing above $3.25/gal on the futures market and $4.00/gal around the country. Diesel demand was also strong as Asian (especially Japanese [because of lost nuclear supplies] and Chinese [due to drought-induced power rationing]) countries used more diesel for power generation than expected. May's weakness in precious metals spread to the energy complex, driving down crude oil and gasoline prices 15-25% to their mid-March levels, as market participants saw S&P 500 earnings misses and climbing weekly jobless claims as portents of economic weakness in the US and possibly worldwide. Natural gas prices followed the rest of the energy complex, weakening in mid-April, climbing to yearly highs by the end of the month, and then plunging back to March/April levels in May – but never broke $4.10/MMBtu, showing the relative strength of this energy laggard. June brought even more fireworks to the energy markets, with extreme moves both up and down in many products. The weakness in US economic statistics hit both Brent and WTI during early June pushing them down near their May lows, but mounting concerns about slowing growth in China and northern Europe finally pushed oil and oil product prices to new quarterly lows. Near the end of June, a new phenomenon happened: the Obama Administration, in league with the International Energy Agency, attempted to manipulate oil prices down further by announcing a release from the Strategic Petroleum Reserve in the US and the equivalent in Europe, allegedly to counter Libyan supply disruptions (which had been going on for much of the spring, at this point). While the announcement did send prices down strongly for a couple of days, increasing demand due to Japanese nuclear power problems (and from Germany's nuclear power shutdown) and China's growing use of diesel due to hydroelectric/drought problems, coupled with continued low output from OPEC countries, led to a rebound in prices at the end of the month. Natural gas continued to bounce off the low-end of its multi-month trading range, buoyed by high usage but held down by record domestic US production.

Other Markets

As mentioned above, longer-term bonds were higher, in spite of strong US Government debt issuance and continued inflationary fears. In April, the US dollar lost ground to the euro as low rates in the US took their toll on investment fund flows. May saw bonds continue to move higher in price (and lower in yield) as investors fled "risk trades" like commodities and energy [winners through April] for the stability and yield of bonds, in spite of lingering concerns about inflation, the US budget deficit and the uncertainty of the US debt ceiling. In June, bonds stayed high initially as equity markets sold off and concerns about Greece and Euro debt pushed investors further into US debt. However, in mid-June (followed by a recovery) and again in late June, bond markets sold off in the face of poor 3-, 5- and 7-year US Treasury debt auctions as bond investors started to get concerned about the end of QE2 and who will be the big buyers of Treasury debt going forward. Also disclosed during the quarter was further buying by Chinese of Euro debt, helping hold up that currency and helping keep a lid on some euro-denominated yields (although not Greek debt).

Going Forward

We don't want to beat a dead horse, but we are still very surprised at financial market participants' "whistling past the graveyard" stance of investing during the second quarter, and we don't believe it can continue for much longer. We have reluctantly moved in recent years to a more macro-economic perspective first look at investing (we had hoped that investing in good companies at good prices would be sufficient for investing but believe recent events require more macro knowledge), and in our mind, almost all macro indicators point toward our "aggressive defense" investing posture being a preferred position for investment results at this time.

First and foremost, we are of the strong opinion that the demands for austerity due to budget restraints (US Government and US state and local governments) and due to funding restraints (Greece, Ireland, Portugal and potentially other European countries) are a drag on economic growth and that monetary stimulus will be called upon (from both the Fed and the ECB) in the future to provide monetary stimulus in the form of buying bonds and guaranteeing price levels, in spite of the inflationary implications of such moves.

Second, we believe that the increased governmental interference and regulation, combined with environmentalists' interests, will retard the growth of new supplies of raw materials, exacerbating an already tight supply/demand situation in precious metals and crude oil, and possibly to a lesser extent in agricultural materials and industrial metals.

As we've stated before, we analyze the macro-economic environment and then try to choose sectors in which to invest, analyzing individual companies within those sectors to invest your capital. Our views on the poor performances of the Fed and US Government

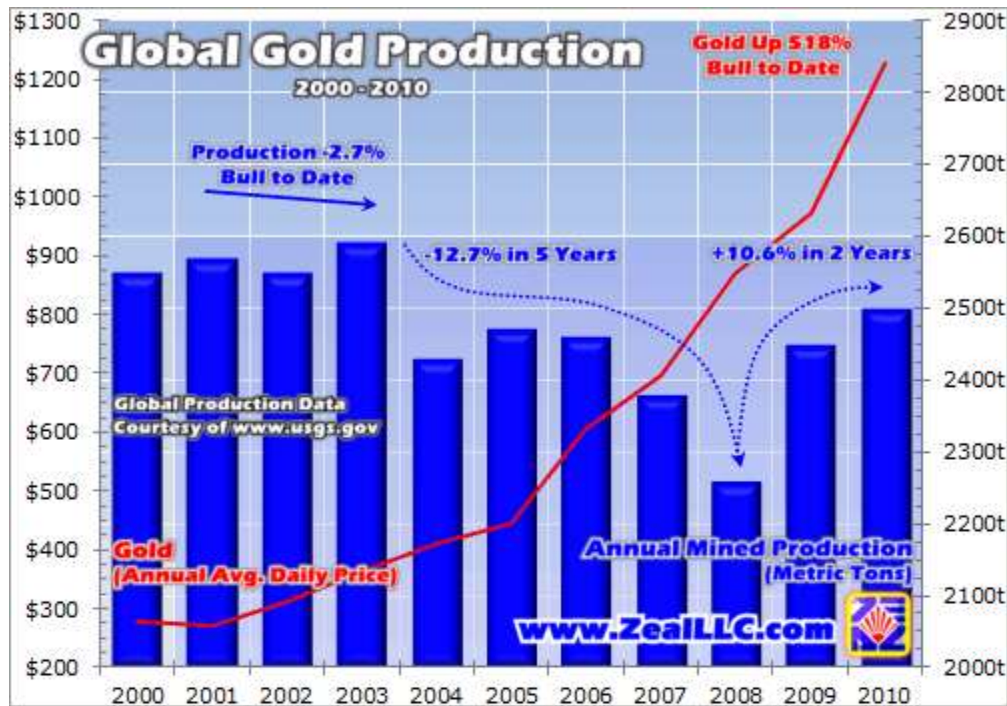
(President, Congress, regulators and others) continue to steer us away from more "bread and butter" US equity investments like industrials, consumer companies, etc. As mentioned above, when the Fed changes monetary policy to better perform its mandates and when the US Government shows true progress toward better fiscal discipline, plans for reining in "out of control" entitlement programs and plans for limiting and starting to pay down debt, we will be much more comfortable with a "broader brush" of investment possibilities. On the other hand, if the Fed continues its US dollar-destructive behavior and government spending is not limited nor are entitlement programs, we'll continue to look at protecting your capital through more "inflation-resistant" investments that we talk about in the prior paragraph. If and when commodities prices go higher in a parabolic manner and former doubters become cheerleaders for even higher prices, we will be looking at exiting our "inflation investments" and look to find stock market bargains, similar to the early 1980s when US stocks proved to be extremely cheap – we sincerely hopes one of the above scenarios happens sooner rather than later.

Precious Metals

The weakness in precious metals equities continues to boggle our minds. With valuations so low, we would think value investors would be extremely interested. With high prices for their products and (as many in the investment community think) energy prices poised to drop, we think that growth investors (at least GARP [growth-at-a-reasonable-price] investors) would be all over them. And yet they languish. One of the research services we follow, the Gold Stock Analyst, calculates that their Top-10 stocks are on average **valued at only 47% of GSA's target price**, which can be said in another way that the gold held by these stocks is judged to be only worth $706/oz. Another metric: the two largest gold mining stocks in North America (and the world), Newmont Mining and Barrick Gold, are both valued at 5.5x their operating cash flow and sport 12x P/E ratios on trailing earnings, while both companies' earnings per share are expected to grow strongly in 2011. Meanwhile, Caterpillar, also considered a cyclical company like Newmont and Barrick, is currently expected (even in a slow growth world economy) to have a 2011 earnings jump but is afforded a 19x trailing P/E and an operating cash flow multiple of 12.6x trailing results. This valuation discount shows the disdain in which these mining stocks are held (could sentiment go much lower?) and that investors don't believe precious metals prices can stay at these levels, although gold (even after being knocked down at the end of June) is still only 6% below its all-time high set just two months ago – hardly a reason to think gold's bull market is over.

Maybe this extreme undervaluation is due to supply and demand. Investors must believe these companies have no growth at all because supply look to be tight: South Africa, the largest gold mining country for decades until 2006, just reported (by its Chamber of Mines) that gold output for 1Q 2011 dropped 9.3% compared to the 4Q 2010, a sizeable drop. The World Gold Council reported in April that at the current rate of Chinese demand for gold, Chinese domestic gold mines could be exhausted **in six years [emphasis mine – KS]**, because China has not responded fast enough to be able to bring

on new gold mines in the next few years. This chart below, from ZealLLC.com, shows how global gold production has not kept up with demand over the past 10+ years of the current gold bull market:



One longer-term prop under gold prices is the prospect of continued central bank buying of gold, mostly from developing countries. Central banks had been large sellers of gold throughout the 1990s and 2000s, with net central banks actually peaking in 2005 at over 600 tons/year. Central banks in aggregate didn't even become net buyers until 2010, so although many central banks have bought in the past couple of years, many of the sellers were themselves central banks (or the IMF). However, central banks are now net buyers, and with such low levels of their reserves in gold, Asian central banks will seek to raise their exposure over time, keeping a bid under the gold price for some time (meager gold reserves examples include China: 1.6% of reserves, Singapore: 2.4%, Taiwan: 4.7%, India 8.2%, all countries worldwide: 11.1% [but this is after 15 years of sales by central banks, so it may represent a very low level]).

Another factor underpinning gold demand is past gold lending which will need to be bought back (at some point). According to CLSA's mid-June "Greed & Fear Report", noted gold analyst Chris Wood says that "Belgian central bank Vice Governor Francoise Masai reportedly told shareholders that about 41% of the central bank's 216 metric tons of gold was on loan at the end of last year, and that the central bank earned a 0.3% return on its loans of physical gold to commercial banks last year." This shows that a large amount of European gold has been lent to banks and sold into the physical market, meaning that there is more and more pressure as gold stays around $1500/oz (or goes

higher) to buy back the "shorted physical gold", which at some point provides more buying pressure on the price. This also begs the question: how much other European (and US) gold is lent out that needs to be bought back at some point? Other central banks have been buying gold, most notably Russia (200-400,000 oz/month during 2011), Mexico (which the IMF in May reported bought 93.1 tonnes of gold in Feb/Mar 2011 to move their gold reserves **from 7.1 tonnes to 100.2 tonnes!**) and even Thailand added 9.3 tonnes this spring. That a lot of gold looks to have been lent out while other central banks are buying will only help support gold prices in the future.

What about silver? Although silver production has risen in the past couple of years, demand has risen faster. According to the Silver Institute, total global silver mining output in 2010 was 735 million oz which only amounts to 70% of 2010 global demand. Peru, the world's leading silver producer, reported a 7.3% decline in silver production in 2010 and China is exporting less silver than in past years because it uses a lot in industrial processes (including the production of solar energy products, many of which are used here in the US). These are the dynamics that drove silver prices higher. And interestingly, speculators' holdings of silver were historically very small when silver made its run to $49/oz in April, meaning much of the buying is thought to be speculative shorts purchasing to cover their short positions, not new speculators throwing in new money to cause a real bubble.

Energy

We at Kanos are trying to keep our eyes on the medium-term, especially in the case of energy, because of the extremely attractive fundamentals for owning energy, energy-producing and energy services/logistics companies going forward. Although the short-term may offer some weakness (which is why we have not added aggressively to our holdings) due to deteriorating economic conditions, we believe the future is bright for both supply and demand reasons.

Obviously, the Libyan supply shutdown (1.6 million bbls/day due to civil war) and lower North Sea production of premium (very light and low in sulfur) crude have raised oil prices, especially Brent (European) crude prices. Another support to worldwide oil prices are the "Arab Spring" conflicts in Syria and Yemen which although they haven't affected large amount of crude exports (both are medium-sized oil exporters [Yemen has seen ~400,000 bbls/day interrupted]), the continuing scenes of protesters fighting to gain a say (or control) over currently-authoritarian governments have many concerned about large authoritarian exporters like Saudi Arabia, Iran, Oman, etc. could face upset. These concerns have kept a "fear premium" in crude, raising prices, which we see continuing as long as fighting continues in at least one of the countries mentioned above (or a new outbreak occurs somewhere).

Importantly, supplies from Saudi Arabia may not be as forthcoming as in the past for two reasons: 1) Saudi capacity levels for crude production may be at or near their current

maximums for all grades but heavy crude, as shown by the Saudis' maneuverings around the June OPEC meeting. Saudi Oil Minister al-Naimi "lobbied for higher quotas" during the OPEC meeting [which would lead to lower oil prices] to show good faith to Western countries that the Saudis were trying to lower oil prices. Meanwhile, the Saudis had surreptitiously raised prices on their all of their crude grades, including heavy crude – thus appearing to look like good guys to the West but charging higher prices to maximize revenue at the expense of consumers; and 2) after OECD countries, led by the US, released crude oil from stockpiles during June, the angered OPEC nations, especially Saudi Arabia (which has acted as the "swing producer" or price moderator since the early 1980s) intimated that they might CUT production to match the releases, which could send prices higher also.

Finally, supplies from other parts of the exporting world are not necessarily available for increased production. First, the North Sea has seen lower production for two reasons: 1) unscheduled maintenance at some of the Brent marker fields (especially the Buzzard field) and 2) a higher tax rate on oil production by the British government which led to some shutdowns of marginal fields. Second, in Iraq, where the IEA expects production to continue to ramp up over the next few years, the southern Basra loading terminal has reached capacity, meaning exports are limited through at least the end of 2011 or maybe even mid-2012. Finally, Iran seems to be producing less than they could sell, as exhibited by JP Morgan's Larry Eagles reports that Iran drew down almost 50% of their floating storage [extra production currently stored in tankers in the Persian Gulf] during May, showing that Iran oil sales far exceeded their May production.

Demand is also a driving factor: Japanese nuclear power utilization was down to 41% of nameplate capacity during May, meaning usage of LNG and resid/diesel fuels for power generation continues to be strong in Japan to offset loss of nuclear power. China's drought has gotten worse, affecting its large rivers and hydroelectric generation, raising China's usage of LNG and diesel fuels for power generation also. Finally, Germany has shut down eight of its nuclear plants and will shut down the rest by 2022, leading to more development of fossil fuel plants (and renewables) going forward, also boosting oil/gas usage in the future. And Italians, in a June referendum, voted to abandon further nuclear development plans, which will skew further development toward fossil fuel plants (and renewables).

Longer-term demand may also be impacted higher after solar physicists of America's National Solar Observatory's American Astronomical Society reported that they believe we may be heading into a Maunder/Dalton minimum for colder weather due to the absence of development of sunspots, the Economist reported in its June 16th edition. Three key elements of new sunspot development, a solar jet stream, strengthening of current sunspots and a solar magnetism migration, are all missing from current sunspot development. Lack of sunspots would lead to changing conditions on the earth: cooler global temperatures (due to lower energy from the sun impacting the earth), lower crop yields (colder weather yield fewer crops per acre, all other things being equal) but much

better global communications (sunspots/solar flares lead to lots of interference of radio waves – their absence would mean much better transmitting and receiving of wireless communications], which could last for 25-75 years – stay tuned.

From a stock market perspective, Raymond James analyst Pavel Molchanov produced a study in June that shows that the energy sector has been underowned by the investment community since reaching its bear-market low in valuation in 1998. The energy sector has produced 15.7% of the S&P 500's operating earnings since 2001 but only has captured 9.5% of the market weighting. Currently, energy is 12.6% of the weighting (slightly above its average 11.8% weighting since 1977, much of which was during the 1982-1998 bear market) while its current S&P 500 earnings contribution should exceed 21% this year! This is certainly because investors think oil in the $90-100s/bbl is unsustainable, but even if oil dropped to $75/bbl, earnings contribution would still far exceed current market weighting. We believe this situation will slowly push up energy share issues over time as more investors raise their weightings to energy equities.

Other Markets

The bond market is in extreme flux as we write this due to a deterioration in rates in late June, impacted by the end of the Fed's QE2 buying of bonds, continued constant rise in worldwide inflation measures and slowly increasing discomfort of sovereign credits. However, the disinflationary forces that pushed down rates during much of the second quarter are still extant: falling home prices, weak aggregate demand for goods leading to lack of need for financing, weak employment markets due to low corporate utilization rates, etc. We believe that after a pause to see if their prior "monetary medicine" has kicked in, the Fed will start again with more monetary stimulus, in forms we've already seen as well as new manifestations: buying bonds (probably by pegging certain Treasury maturities like 5- and 10-year), providing new, very inexpensive borrowing facilities for banks (and possibly companies, including possibly small companies), and even purchase/sale of other assets (possibly equities, indices, maybe even commodities). Poor 3-, 5-, and 7-year Treasury auctions at the end of June show the stress Treasuries might face in the future. And the end of QE2's "POMO" (permanent open market operations) had the Fed buying recently-auctioned bonds all spring, punctuated by June 30's purchase of the 7-year Treasuries auctioned on 6/29 sold to the Fed on 6/30! That is the definition of Fed monetization – and we don't think it will be the last example of it this summer.

The Fed may have to step up because one big former buyer and holder of Treasuries, China, has said it wants to lower its reserve levels (deploying the money) and lowering its reserve exposure to the US dollar, which right now is mostly in US Treasuries. In fact, China has been buying Eurobonds and is looking to continue to buy raw materials around the world. Japan, traditionally another big buyer, is mired in efforts to ease monetary policy and repatriation of capital to pay for the cleanup and rebuilding after March's earthquake and tsunami. The Arab states, traditional buyers of some Treasuries, also may

be less enthusiastic buyers after the Obama Administration angered them by releasing barrels from the Strategic Petroleum Reserve. Thus, the big question around bond desks these days is: Who will buy the bonds? In a scary note, Tyler Durden of ZeroHedge points out in his July 1st post titled “T-Minus Two Months Until The $500 Billion Rolling Debt Ticking Timebomb Goes Off” that with approximately $467 billion of T-Bills outstanding, “What people don’t realize is that…unless the UST can roll its debt not on a monthly but now weekly basis in greater and greater amounts, the interest rate doesn’t matter. *All it takes is one semi-failed auction and it’s game over as hundreds of billions in [T-]bills become payable.”* As stated above, we believe the Fed would “come to the rescue” and buy up the T-bills, but it would mark a sea change in confidence and would change the financial world as we know it. We hope government and Fed officials can “navigate these shoals” and make sure the US does not face these dire consequences. Our study below lays out some thoughts related to the above.

Kanos Quarterly Commentary

“The Fed’s Plan – Inflation (?!)”

The economic malaise we find in the US (that has continued really since 2007) is the consequence of the easy money policies of the Fed of the 1990s/2000s and the increasing consumption it allowed, fostered by the huge buildup of debt (both public and private) since the 1980s.

Housing

A perfect example of this is housing. The 1980s launched a housing boom as Americans built larger houses with cheap materials (from the commodity bust after the boom of the 1970s) and falling interest rates, after Fed Chairman Volcker stamped out inflation with near 20% interest rates in the early 1980s. After a large hiccup in prices due to the recession of 1990/1991, housing prices generally rose as interest rates continued down, and super low interest rates allowed housing prices to stay up during the recession of 2000-2002. Housing prices peaked in 2006-2007, as extreme ease of financing (liar loans, etc.) and relatively low interest rates allowed those last and only marginally economic houses to get built.

Now the “Great Recession” has sapped Americans wealth, liquidity and future prospects. Housing prices continue to fall because high leverage on housing purchases have left many with negative equity in their houses (some have calculated this to be as high as 40% because so many refinanced houses and took out equity). So how and when are housing prices going to stop going down or even go up?

The easy answer is when someone can buy the house, fix it up to living standards and either sell it or live in it feeling that the value is not going to drop another 20% after they

buy. So when do we reach that point? Many had thought we might have reached that point in 2010, but 2011 has shown continued weakness in housing prices.

The Fed believes, with perspective from the Great Depression, that extreme liquidity will overcome the deflationary effects of falling housing prices, stagnant wages and a dearth of new jobs and the weight of carrying high debt loads. Thus, the Fed still believes that they must continue to push liquidity into the system to cause inflation – yes, cause inflation, so that prices will go up, allowing people with assets and high debt loads to escape the deflationary effects that are depressing the economy.

Stock Market

The Fed also sees the stock market as an integral part of this inflationary strategy. If the Fed can boost asset prices in the form of the stock market, it allows people who own stocks to gain paper wealth, or take profits and redeploy those profits into the general economy (hoping that this creates jobs) AND to give pension plans returns that allow them to dodge underfunding and pay promised amounts to pensioners. They also believe that money first goes into the financial markets and then gradually is inserted into the economy through capital improvements, hiring of employees, new plants, etc. (and we believe this is correct thinking, albeit in a functioning capitalist society with low government interference).

Economy

The Fed's extension of credit and insertion of extreme liquidity in the economy has so far not been as effective as they would have liked. Unemployment is still higher and is rising again, wages are generally stagnant and housing prices, after plateauing, are dropping once again. According to analyst Jim Rickards from Omnis, this has to do with a lot of the inflation being "produced" in the United States by the Federal Reserve is being exported to other countries, like those that create a lot of the finished goods we consume like China, Vietnam, Japan, etc. and raw materials from Australia, for example. Those countries receive our US dollars for the goods, then those countries' central banks buy the US dollars and give local currency in return – this creates inflation because more local currency immediately enters the local economy (than would be warranted by economic conditions), causing inflation in prices of goods. Thus, those countries have been forced to fight the inflation that the Fed had wanted to generate to fight off deflationary forces in the US by raising their interest rates.

Eventually, higher interest rates and the inflation-caused higher wages from East Asian countries, combined with a weakening US dollar [more Fed-created dollars leads to lower US dollar value vs. other currencies], will cause prices of many goods to rise in the US, allowing the inflation that the Fed has engineered to appear in the US. We have obviously already seen that in raw and low value-added products like crude oil, gasoline, wheat, corn, etc. However, inflationary pressure has already impacted other products too,

like manufactured foods, where companies have tried to hide rising prices using smaller packaging or smaller amounts of the goods without changing the packaging. But wages have been brought much closer to balance than in recent years, with Chinese wages now within about 25% of Mexican and low-end US wages, meaning manufacturing in North America is becoming more and more competitive on the world market (however at the cost of American's standard of living – lower dollar means lower wages on a "world scale"). This is what the Fed's monetary engineering is trying to accomplish.

Banks

The Fed is very frustrated with the situation of US banks because they have really been so much more of a mess than anyone imagined. Virtually zero short-term interest rates and huge spreads to longer-term interest rates have been a very effective cure for bank ailments in the 1980s Latin American debt crisis/early 1990s recession and the late 1990s Asian bust/Russian debt crisis. However, almost 2 ½ years after lowering short rates to near zero levels, banks are still in poor shape. Why? Most probably, it is because the problems within the banks were much worse than even the financial regulators thought after 2007/2008/2009. It appears that many of the housing loans that were prime (not ever considered subprime, Alt-A, or anything exotic) also stopped performing, as even people who put down 20% and borrowed only a $100,000-200,000 still defaulted after some regions experienced a 40-50% drop from peak housing values and experienced high unemployment. Thus, mortgage portfolios at banks might still be in workout mode, almost 5 years after values peaked.

In addition, banks aren't lending much, feeling like there aren't great credits to lend to and buying US Government bonds allows them to commit less capital [they don't have to keep as much in reserve for US Treasuries], get a return [from the spread between their near 0% borrowing costs and Treasury yields] and minimize default risk. Meanwhile, world financial regulators trying to finish up the "Basel III" guidelines for banks have raised the amount of capital banks must hold (from Basel II levels, which obviously proved insufficient) and there has been talk in June of an extra 2-2.5% for large banks to allow for their systematic importance (their failure could bring down a country's financial system). This means banks need more capital, probably in the form of more equity, and lending to businesses will only make them need to raise even more capital. Thus, the "fixing" of the banks in the US (and even more worldwide, especially in Europe) is ongoing, which means the health of the US economy is still in question as financing for upkeep, upgrading and new facilities is restricted by tight bank lending standards. And don't forget, the dirty little secret that no one likes to utter is that the Fed is using what would be the earnings of savers (if interest rates were at more normal levels – probably close to 3-4%) to supplement bank earnings by keeping short rates near zero; thus, US grandmas are keeping the Citigroups of this country alive by donating their interest earnings to the cause.

So, where does that leave things? We believe the Fed feels like it is on the correct path, trying to bring the US economy out of its malaise through causing inflation and getting more competitive with a lower dollar. Meanwhile, it is getting flak from many quarters because of higher inflation in consumer prices (which react much quicker because products compete around the world daily); wages/employment and housing prices require much more time for this inflation to take effect. Thus, the Fed has to walk a fine line by professing to be more vigilant about rising prices while making sure there is enough "liquidity medicine" to "heal" wage levels and housing prices through inflation. The Fed will continue to err, as they have said many times in the past, on the "easier money" side to make sure the cure occurs, but must appease inflation hawks by showing that they have exit mechanisms from the current policy and that they are looking out into the future when they will resume normalized monetary policy.

All this means that the Fed will have to continue its easy money policies as the most recent episode of higher unemployment, coupled with the resumption of falling housing prices, means that more needs to be done. Thus, there will have to be some kind of continuation of quantitative easing, over and above the reinvestment of principal already contemplated, so that the "work" of the inflation that the Fed has already accomplished isn't "lost". ***Late breaking news as of 7/12/2011*: The minutes of the Federal Reserve Open Market Committee meeting held June 21-22, 2011 contained this passage:**

> ***"Some participants noted that if economic growth remained too slow to make satisfactory progress toward reducing the unemployment rate and if inflation returned to relatively low levels after the effects of recent transitory shocks dissipated, it would be appropriate to provide additional monetary policy accommodation....A few members noted that, depending on how economic conditions evolve, the Committee might have to consider providing additional monetary policy stimulus, especially if economic growth remained too slow to meaningfully reduce the unemployment rate in the medium run."***

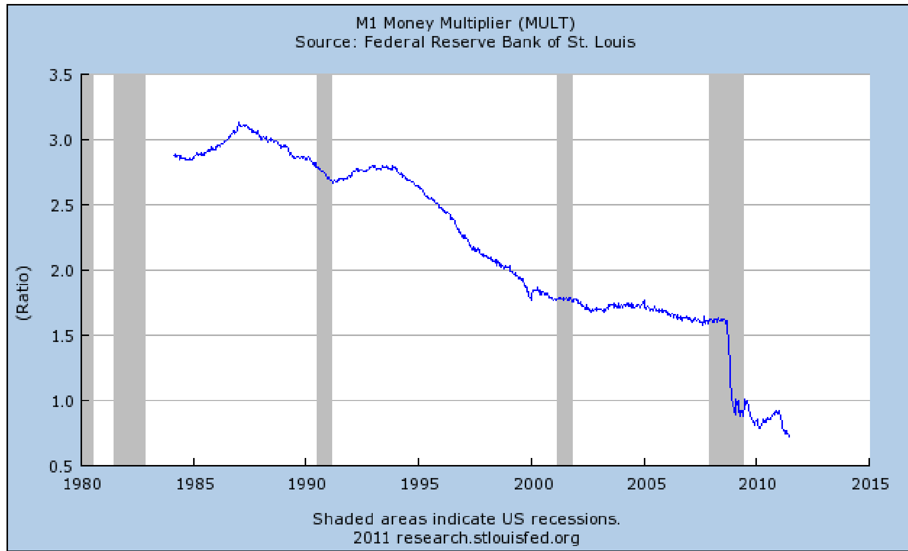
And on 7/13/2011 before the House of Representatives, Fed Chairman Bernanke said in his prepared remarks:

> ***"The possibility remains that the recent economic weakness may prove more persistent than expected and that deflationary risks might reemerge, implying a need for additional policy support. The Federal Reserve remains prepared to respond should economic developments indicate that an adjustment of monetary policy would be appropriate."***

To us at Kanos, this appears to put some version of QE3 on the table for implementation this summer.

As a final illustration of what the Fed is facing, here is a graph constructed by the "statistical branch bank" of the Federal Reserve System, the Federal Reserve Bank of St. Louis, that shows the M1 Money Multiplier which is the ratio of M1 (cash and checking account) to the Adjusted Monetary Base (cash plus bank reserves held on account at the

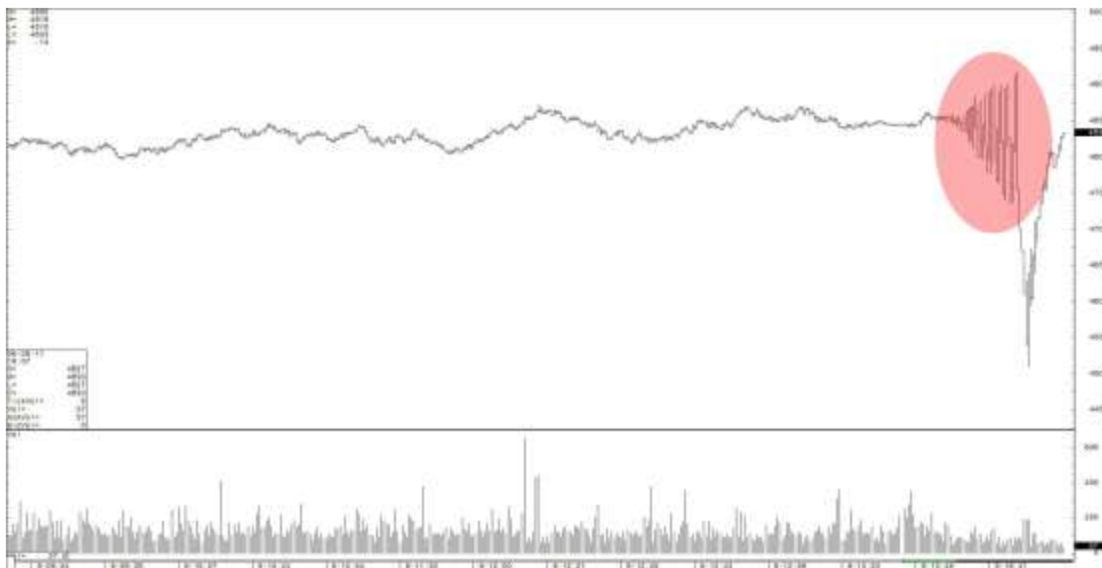
Fed by banks). This graph shows that the Fed has radically increased the Adjusted Monetary Base since 2009 (QE1 and QE2), but M1 is not growing nearly as fast, meaning the money created by the Fed is staying in reserves and not getting out into the economy. Thus, this is an illustration of how the Fed's policies have not yet worked or in popular parlance, the Fed is "pushing on a string", trying to get money to circulate.



Final notes

Natgas "Flash Crash" highlights Out-of-Control Markets:

On June 8th, the following trading pattern in natural gas futures trading (chart thanks to ZeroHedge):



The red-shaded section shows a high-frequency-trading algorithm program that bought and sold highs and lows until it found the "bottom of the orders" and drove the price down, taking out resting orders and causing chaos over a short span of time (and after the regular session had ended – the trading was during "after hours"). According to Nanex, a data-feed and analysis company: "*On June 8, 2011, starting at 19:39 Eastern Time, trade prices began oscillating almost harmonically along with the depth of book. However, prices rose as bids were executed, and prices declined when offers were executed --* ***the exact opposite of a market based on supply and demand…*** *Upon closer inspection, we find that price oscillates from low to high when trades are executing against the highest bid price level. After reaching a peak, prices then move down as trades execute against the highest ask price level.* ***This is completely opposite of normal market behavior."*** To us, this appears to be a trading strategy to clear out all the bids and offers, in an after-hours environment when fewer are trading, so that the price can then be manipulated, in this case downward. If the trading algorithm can eliminate competing offers, it can eventually short-sell to the limit orders sitting below where the market was trading and "cascade the price down", eventually buying back the shorted positions at the bottom (see the two spikes in volume at the bottom, when the trader has bought back his short positions). This is a very good illustration of market manipulation, which is illegal under SEC laws (for stocks and bonds) and Commodity Futures Trading Commission laws (for futures, swaps and options). This is the same "flavor" of after-hours, high frequency trading that set off the silver correction of May 1-2, and both the above natgas and the early May silver trading are examples of the law being broken and little, if any, action occurs to either stop such trading action and/or punish the perpetrator(s).

We believe that free markets are the hallmark of capitalism, but that laws on the books should be applied to lawbreakers. We see almost no value in high frequency trading (HFT) because the alleged rationale for the practice, market liquidity, is not guaranteed, like it was when specialist systems (which have been virtually replaced by HFTs) were required to provide liquidity to stabilize markets. In fact, HFTs caused the flash crash of May 6, 2010 when almost all of them stopped trading for a period of minutes and the Dow Jones Industrials dropped more than 900 points before recovering more than 600 points before the close.

We believe that the financial markets won't be healthy until these kind of trading programs are regulated and controlled. Trading which goes against normal market behavior and is the opposite of what would be dictated by supply and demand subtract value and confidence from markets. Lack of confidence and value lead ultimately to lower volumes, higher costs, wider bid/ask spreads and less healthy markets. If society is going to rely on markets as much as it has heretofore, authorities must to a better job of policing and prosecuting illegal behavior.

Obama's Own Words

Dennis Gartman recently pointed out President Obama's words about the debt ceiling debate in 2006 when he was just the junior senator from Illinois. Here are Obama's words and Gartman's comments on those:

> ***"The fact that we are here today to debate raising America's debt limit is a sign of leadership failure. It is a sign that the US government cannot pay its own bills. It is a sign that we now depend on on-going financial assistance from foreign countries to finance our Government's reckless fiscal policies…. The cost of our debt is one of the fastest growing expenses in the Federal Budget. This rising debt is a hidden domestic enemy, robbing our cities and States of critical investments in infrastructure like bridges, ports and levees; robbing our families and our children of critical investments in education and health care reform; robbing our seniors of the retirement and health security they have counted upon… Every dollar we pay in interest is a dollar that is not going to investment in America's priorities. Instead, interest payments are a significant tax on all Americans — a debt tax that Washington doesn't want to talk about. If Washington were serious about honest tax relief in this country, we would see an effort to reduce our national debt by returning to responsible fiscal policies. Increasing America's debt weakens us domestically and internationally. Leadership means that "the Buck stops here." Instead, Washington is shifting the burden of bad choices onto the backs of our children and grandchildren. America has a debt problem and a failure of leadership. Americans deserve better."***

Adds Gartman:

> "We cannot possibly agree with the President more. We do indeed have a debt problem here in the US, brought about by spending programs that are out of control and must be brought under control. We agree that we are leaving these problems to our children and grandchildren unless we address these problems swiftly and with almost recklessness. We agree with the President that the debt ceiling is a sign of "leadership failure" but we believe that the problem and failure is now his. As the junior Senator from Illinois, Barrack Hussein Obama was a bright young man intent, apparently, upon doing the right thing; as a President, it appears he's forgotten everything he and we knew to be true. As the junior Senator from Illinois he knew that "The Buck stops here," but as the President he knows only that "Bucks inflate here."

The Managers of Kanos Capital Management

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