KANOS
CAPITAL MANAGEMENT, LLC

Third Quarter 2022 Investor Letter

Portfolio Comments

The third quarter markets were characterized by strong moves both upward and downward. Markets rallied at the beginning of the quarter as better-than-expected earnings and employment statistics led many investors to put money to work after the June lows. However, persistent inflation led central banks to accelerate their raising of interest rates, dampening investor enthusiasm for stocks as interest rates continued their rise. As has been evident for most of the year, the war in Ukraine, continued high inflation and high energy prices contributed to worldwide economic weakness and downturns in US and international markets. The strength of the US dollar and its effects on liquidity in world financial systems, combined with China's continued lockdowns and economic malaise, led investors to continue selling equities around the world, leading to averages dropping to year-to-date lows. High energy prices continued to cause economic stress during the quarter, with European natural gas prices rising to historic highs, pushing up natgas, coal and electricity prices worldwide.

Kanos portfolios performed about in-line with US markets during this difficult quarter, as energy, agricultural and fertilizer stocks rose but metals, healthcare and defense positions swooned. Leaders to the upside were energy stocks, like ConocoPhillips (+15.1%), Ag stocks like Archer-Daniels (+4.2%), and fertilizers like CF Industries (+13.0%). Downside leaders included precious metals like Agnico Eagle Mines (-7.0%), pharmas like Merck (-4.5%) and Johnson & Johnson (-7.2%), and defense like LockheedMartin (-9.5%). Commodity stocks were generally weaker, but energy pipelines held up and continue to pay good dividends, like Kinder Morgan (+0.8%). Fixed income investments were weak as were our preferred stocks, but they continue to deliver good income with lower risk in most cases.

The markets experienced losses in most assets, although there were two equity rallies during the quarter. In US equity markets, the S&P 500 lost -4.86% during the third quarter, while the Dow Jones Industrials lost -6.17% and the tech-heavy Nasdaq Composite lost -3.9% (all performance numbers reflect total returns). There were only two quarterly S&P sector winners: Consumer Discretionary (+3.89%) and Energy (+1.65%). All other sectors showed losses, with the worst performances from Communication Services (-11.58%) and Real Estate (-11.03%). Stock indices ended the quarter at yearly lows, with the S&P 500 having lost -23.87% YTD, the Nasdaq Composite -32.88% and the Dow Jones Industrial Average down -19.72% YTD, ending at 28.725.51. Like last quarter, the US dollar was the only real safe haven, with the WSJ Dollar Index gaining another +6.74% for the quarter. Despite the dollar's strength, US bonds had another awful quarterly performance, as shown by the S&P US Bond Aggregate Bond Index, which lost -4.22% (down -13.45% YTD) while the iShares 20+yr Treasury Bond ETF lost -10.81%. Commodities were mixed during the quarter with only a few commodities gaining: Nymex US natural gas gained +24.74% while orange juice (+6.54%), wheat (+6.07%) and cattle (+0.33%) also rose. Last quarter's energy winners, RBOB gasoline (-32.25%) and WTI crude (-24.84%), were big losers this quarter. Precious metals also dropped in price, with gold down -7.85% and silver down -6.52%.

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Introduction

The markets continue to react to the impact of still high inflation, moderating earnings gains and central banks that are still raising rates, albeit into slower growth (or even weakening) economies. The resilience of employment has been the one big strength of the US economy, allowing economic growth to expand but at a snail's pace.

Economy

The US economy grew during the third quarter, albeit slowly at 2.6%, after two quarters of small negative growth. Growth is uneven by sectors, as some consumer-facing businesses are feeling slowdowns while many industrial companies continue to grow their businesses.

Capacity constraints and supply problems appear to be lessening in most industries, returning many supply chains to more predictable levels, although still longer than pre-Covid lockdowns. However, specialized items are still in short supply and take weeks longer than normal to procure.

In spite of the above, inflation continues to run at 40-year highs, with higher energy and commodities moderating from summer levels but their influences feeding into the prices of finished goods and services. These price hikes have combined with high employment to make services inflation also the highest in forty years, showing that inflation is a widespread problem.

To combat the still-high measured inflation, the Fed continues its hawkish stance, and has vowed to do so with each new high inflation report. Fed speakers continue to say in speeches that rate hikes will continue in the near future, and the endpoint interest rate has risen to between 4.75-5.25%, which means at least 0.75% more in rate hikes (at its December 2022 and January 2023 meetings). While rate hikes generally take some time (i.e., months) to work their way through the economy, higher short-term interest rates have driven up mortgage rates of all maturities, hitting the homebuilding industry hard as buyers back off due to far higher mortgage rates, pricing buyers out of their desired price ranges and dropping mortgage activity to pre-2003-2007 housing boom lows.

Employment has stayed high as companies heed the lessons of Covid and try to keep their best workers since labor shortages still seem to exist. Many companies would like to upgrade the quality of their workforce, but many have been scarred by missed business due to lack of labor post-Covid. If the US economy continues to grow, even slowly, companies can continue to "run heavy" to ensure no loss of business due to lack of employees. This has also kept up inflationary pressures as employees have recognized their bargaining power and received raises, further pushing up inflationary pressures in the economy.

We believe that many inflationary forces will continue because they are being driven by supply factors: underinvestment in commodities across the board and lower than inflation costs of living increases for workers for the past few years meaning higher prices are needed to incentivize marginal increases in supply of materials and labor. Until the country (and the Biden Administration along with the rest of government) starts to recognize that incentivizing investment in supplies of metals, foodstuffs and yes, traditional forms of energy/infrastructure (like oil, natural gas, etc. plus energy infrastructure like pipelines and refinery expansions), inflation will not being going away quickly.

The Fed continues to believe that they can squelch inflation by raising interest rates and reducing demand, which will drive down prices and moderate inflationary forces. In a more traditional economic situation, this is probably true: raising costs to reduce demand will indeed do so. However, part of this "inflation equation is inadequate supply. Raising costs will also reduce supply as the price of development rises due to higher financing costs, and lower demand reduces producers' incentives for further capacity expansion, limiting further supplies. It is a difficult problem for government and regulators to understand since the only tools to fight supply constraints quickly and effectively are fiscal incentives to expand production, which government agencies are seemingly not enthusiastic about doing, considering the apparent anti-energy and anti-metals & mining bent of many US government agencies, lawmakers and regulators. But we do see higher interest rates pushing down economic growth, thus helping push down prices. However, we think there will then be a surprise at how persistent inflation is, going forward.

On the other hand, current consumer spending statistics show aggregate spending barely keeping up with inflation, and we expect that trend to continue. Statistics show that the savings many accumulated during the Covid lockdowns and afterwards have been almost completely used up, while revolving credit (credit card debt) continues to grow as consumers use credit cards to maintain their lifestyles – a trend that continues from earlier in the year but cannot go on for more than a few months at a time.

Asian economies also seem to be maintaining slower growth, although the biggest, China, is more opaque and is less easy to analyze. They profess to be growing at low-single digits in GDP (latest report at 5.5% annualized), but Chinese government statistics try to avoid bad news, especially in and around the recent Chinese Communist Party Congress, the every-five-year "confab" where President Xi was recently chosen for a new five-year term. Overbuilt real estate and interruptions caused by a big drought have caused further slowdown in their economy. In addition, the Chinese government's continued Zero Covid policy continues to close sections of the Chinese economy due to small outbreaks, continuing the stunted growth of the industrial economy, causing more weakness. As we found out at the end of the Party Congress, where Xi's predecessor Hu Jintao was unceremoniously escorted out, Xi's authoritarian ways are getting more entrenched, which is considered bad for the economy as government directs even more economic activity (not as well as private enterprise allocates capital). Other Asian economies are growing at reduced rates as the post-lockdown economic activity boom moderates and demand for goods and services slows.

European economies are benefitting from a summer/fall burst of economic activity from tourism and post-lockdown activity, but industrial activity is already showing weakness as the high cost of energy, exacerbated by the Russia-Ukraine War and the interruption of Russian energy supplies, takes its toll on costs of operations, as well as the cost of living across Europe where sky-high electricity bills are already causing economic upset across the continent. We believe Europe will enter recession as energy costs continue to crimp industrial activity and also adversely impact consumers' purchasing power during this fall and winter.

Bottom line: The US economy has held up better than we thought considering some of the weakness observed earlier in the summer. However, higher interest rates are taking their toll on business and the high cost of everything, especially food and fuel, are taking more and more of consumers' purchasing power, leaving less for discretionary spending and thus slowing economic growth. Chinese economic weakness and lockdowns drag down Asian growth, while high energy costs and war-stunted economies in Europe retard growth there. We see more of the same as central banks, led by the Fed and followed by the ECB, continue to talk hawkishly and raise rates at the rest of the meetings in 2022.

Currencies

The US dollar is easing downward in the fourth quarter after setting a multi-year high in September. The Fed's rapid raising of interest rates had convinced many of the world's investors that it was fighting inflation with more resolve than other central banks, and the resultant interest rates were more attractive for many of the world's investors than alternative cash and fixed income markets, pushing up the demand, and thus price, for dollars.

Other central banks have started to slow down their fight against inflation: both the Bank of Canada (BOC) and the Reserve Bank of Australia (RBA) raised interest rates at their most recent meetings by less than expected. The European bank, the ECB, had been slow to raise rates, thus had been considered "behind the curve," but it is moving quickly now, being the "toughest" (with 75 basis point raising) lately.

The Fed is now trying to manage its resolve in fighting inflation, suddenly with an eye on the economic cost; FOMC members want to mitigate an economic slowdown and keep consequences palatable while trying to keep anything from blowing up.

The Bank of Japan (BOJ), due to its need to anchor long-term rates due to the large amount of debt outstanding by the Japanese government and industry, continues to peg the 10-year JGB, meaning that currency creation continues unabated, driving down the yen past 150 per dollar, a level not seen since 1989 before it bounced back somewhat.

The problem with a still-strong dollar is that the rest of the world suffers even more in an inflationary environment: since many commodities are quoted in dollars, especially crude oil and other energy products, and high demand has driven commodities to the high end of their price ranges, they are "doubly expensive," reflecting both high energy costs and high dollar prices. Example: if oil at the end of 2020 was approximately $50/bbl with the yen/US dollar at 103, meaning one barrel of crude oil costs: 103 yen/$ * $50/bbl of oil = 5,150 yen / bbl of oil. Today, with 150 yen/$ and crude oil at approximately $85/bbl, crude oil in Japan costs 150 yen/$ * $85/bbl of oil = 12,750 yen or 148% higher, while oil is only 70% higher in dollar terms. That shows how other countries are suffering not only from higher commodity prices but also from a higher US dollar. No wonder investment professionals expect the high dollar to "break something" in the financial markets in the near future.

As more evidence of economic weakness starts to appear, we expect the Fed to slow down on further rate hikes but probably not start to talk about when rate cuts may happen. The Fed is caught between trying to continue the fight against inflation while not causing any blowups or pushing the US economy into recession.

<u>Bottom line:</u> The US dollar has stayed strong but the "monetary medicine" of high rates has started to bite, leading many market players to determine the dollar has peaked, although it is still strong. The timing of when the dollar may weaken is very difficult to determine, so we are still on the sidelines as far as currencies go. Other currencies, while weak against the dollar, have started to recover somewhat as each central bank has started to fight inflation more heartily with larger interest rate increases. How long each bank can hold this up in the face of anemic economic growth is the big question – we don't think they will be able to do so for very long, meaning inflation will persist and stay far above the 2% range.

Equities

US and world equity markets have bounced again in the fourth quarter, as market participants gauge that inflation has peaked and companies' earnings have not been as bad as feared. While many stocks have dropped in price over the year, we still don't see this as the bottom because higher US interest rates, which lead to lower valuation multiples, continue to combine with falling earnings estimates to produce lower price environment for many US growth stocks. Post-Covid boom extrapolation had led stocks higher, goosed by QE and zero percent interest rates. Now, those estimates are having to come down, and large institutions are slowly moving to "right size" their positions in many mega-cap stocks, keeping pressure on their prices for the foreseeable future.

Meanwhile, we expect industrial/infrastructure/commodity stocks, led by energy stocks, to continue to have strong demand for their products due to past year shortages, underinvestment of past years and planned reinvestment due to reshoring of industry in the West / incremental demand, due in part to the Russia-Ukraine War. Economic slowing around the world will temper this demand somewhat, as weak equity prices during the last six-month show, but years of underinvestment and the reshoring of industries due to the 'new cold war' mentality of the Russia-Ukraine War and the now-overt competition with China will keep demand strong. This obviously includes defense industry stocks, which we see as attractive for the long-term as countries use all of their pre-war stockpiles of weapons and ammunition, leading to a multi-year demand for replenishment.

On the more humane side, now that Covid is mostly behind us, at least in the Western world, we believe the pharmaceutical industry can concentrate on further developing and introducing many more new pharmaceuticals that will replenish their pipelines and lead to attractive long-term holdings.

As far as China is concerned, the Chinese Party Congress showed us that China is growing the government's reach into their private/corporate economy, pushing for "Shared Prosperity" and other ways the government will act at odds with shareholders in Chinese companies. Thus, Chinese stocks have traded down to multi-year lows, and there is widespread worry that supply chains involving Chinese companies will continue to be less reliable (or worse) in the future. We have been worried about eroding shareholder returns in China, and now we believe Chinese stocks and stocks that supply China are uninvestable. Thus, we will steer clear of Chinese and Chinese-oriented companies, although we favor commodity companies, many of whom sell the majority of their output to China or Chinese companies, which are perpetually short commodity inputs trying to supply the Chinese population.

<u>Bottom line:</u> In spite of the US economic slowdown and probable looming recession, we continue to like stocks in a number of sectors that have attractive supply/demand fundamentals and some kind of pricing power. Most stocks have suffered this year, especially during the past few months, as investors anticipate a recession and follow the "playbook" that flagging demand will lead to lower prices and thus lower profitability. We still think that supply problems in aggregate will allow well-positioned companies to profit from supply in situations with both demand AND supply constraints. We like our positions in the energy, defense, pharmaceuticals and commodity sectors/industries. We continue to look at beat-up sectors for opportunities, but with recessionary conditions occurring/approaching, we are not yet ready to commit much capital to growth until we see more of how the Fed acts and the economy responds.

Bonds

Bonds are continuing their worst year in decades as inflation continues high, and central banks continue raising short-term interest rates at each meeting, pushing down bond prices as rates and rate expectations continue to head higher. Lately, rates have come down somewhat as the Fed has come off its "max hawkishness" rhetoric and inflationary pressures have not continued to climb, but we see interest rates staying at these high levels as the Fed continues to raise short-term rates (albeit at a slower upward pace) and inflation, while moderating, continues are above central bank targets.

The bond markets have been through so much stress, mostly because rates have gone from near 0% (or even negative rates for Europe) to more traditional mid-single digit interest rates, which has meant capital losses for bonds. The Fed's rapid increase in rates, which pundits commented might "break something," seems to have found its first big victim: the United Kingdom's pension fund community along with the British Gilt (long-term government bond) market. In late September, the UK government announced new fiscal plans that the market considered inflationary, and investors sold Gilts, driving down their price and driving up long-term interest rates suddenly. This move led to some pensions facing margin calls on derivative positions they held to satisfy long-term exposures in their portfolios. A number of pensions faced forced liquidation of pension positions (in a weak market) to raise cash to cover their margin calls essentially on short bond derivative hedges. This led to the BOE (the UK central bank) to step in and act as the buyer of last resort for Gilts, which essentially re-established quantitative easing on a temporary basis just as the BOE was starting quantitative tightening! This move by the BOE pushed up Gilt prices, pushed down Gilt yields and lessened the financial stress, allowing pensions to sell assets and meet margin calls, at least for the time being. The stress led to the forced resignation of the new Chancellor who had proposed the plan that initiated the trouble, and it eventually led to the resignation of the new Prime Minister, Liz Truss.

We relate this incident because it is a good example of a situation that "blew up" due to rising interest rates from a very low yield environment of the last couple of years. Such low interest rates caused people to act in different ways than in a normal interest rate environment, and we believe there is more stress in the system due to the rapid rise of interest rates by central banks. In fact, this has been the fastest rate increase regime since at least 1982, and quickly raising rates makes it harder for market players (like long-term holders like insurance companies, pensions, sovereign wealth funds, etc.) to adjust positions that suffer from the change.

Treasury bill and note rates continue to be elevated, with rates high across the yield spectrum, as the Feds' QT program and the Administration's financing of large deficits continue to put Treasuries on the market. In addition, the raising of interest rates has driven up short rates so fast that market participants anticipate that the US economy is either in or going into recession, as evidenced by the inverted yield curve: the spread of 2-year and 10-year Treasury Notes maintaining at least a -0.40% spread, a condition that has occurred before every recession in the past few decades (the level is currently -0.55%, an extreme level).

International rates, while moving up, are still lower than US rates, so there is no interest in going offshore for yield, especially with the dollar having been so strong. While the dollar appears to have peaked, we do not trust international central banks to be resolute when their countries start to show recessionary impacts; thus, we are not interested in international bonds currently.

<u>Bottom line:</u>
We continue to hold some bonds for some income for risk-averse clients, but we don't think bonds are attractive for large allocations of capital at this time due to inflation and rising rates.

Energy

Energy prices fell back during much of the third quarter, but energy stocks, after suffering during the second quarter, were more resilient, one of only two S&P equity sectors that rose during the third quarter, helped by strength in natural gas prices for much of the quarter. We continue to think that attractive fundamentals for crude oil, products like diesel, heating oil and gasoline, as well as natural gas, will underpin energy companies' profits in the fall and winter, keeping energy positions as a must-hold for our portfolios.

As noted in earlier letters, the European energy situation continues to keep prices high as demand is expected to outstrip supply due to restrictions on Russian energy supplies, some of which already apply and some of which go into effect in early December. The threat of a cold winter in Asia has also limited some supplies going to Europe, meaning high prices remain in effect as winter approaches, continuing to highlight US energy suppliers' attractiveness.

While the US has avoided some of the extremes of the European energy situation, higher oil and natural gas prices have impacted US consumers too, leading to not only high gasoline prices (which have moderated throughout the summer) but also higher diesel, natural gas and electricity prices. The following chart (from Tracy Suchart's 10/31 Tweet on Heating Oil) shows the current worldwide inventories of "middle distillates," which include diesel fuel, heating oil and other fuels. The dark blue series shows the weekly inventory levels, which are lower than the last five years (and trending downward). The Northeast US still uses a fair amount of heating oil for winter heating, and diesel is used worldwide to move anything/everything the last few miles by truck – so the lack of distillates will affect energy availability and prices for the foreseeable future.

Natural gas prices are lower in the US, but they don't supply all regions' full demands, like New England. This winter's New England natural gas prices are going to more closely resemble sky-high European gas prices since New England cannot receive US-sourced LNG (due to the 1920 Jones Act which requires domestic ships to move shipborne freight [or energy products] between US ports). No US shipbuilders have built LNG ships, so there are no Jones Act ships to move US Gulf LNG to the East Coast. Since pipeline projects and expansions have been blocked / squelched by environmentalist-influenced governments and regulators, natgas is constrained to the region, and New England normally supplements natgas supplies with imported LNG. Since such LNG is now priced at a world-market premium, we have a situation that may cause extreme prices here in the US, which could cause some extreme hardship for New Englanders.

Bottom line: We continue to favor energy investments, including supermajors, independent producers, pipeline/midstream companies, refiners and even coal companies. We believe they will be volatile, as investors evaluate whether supply is sufficient for worldwide consumption this winter or whether rationing energy by price could occur. However, chronic underinvestment combined with continued worldwide growth in demand means there will be good support for prices over time as producers bow to market forces and return much of the cash generated to owners instead of the constant expansion of the last two shale booms of the 2010s.

Commodities

One of our ongoing theses is that the world's underinvestment in commodities over the past 8-10 years will ration supplies with higher prices as the world continues to grow. The pandemic shutdowns led to further supply interruptions of many commodities , and the low metal and ag product prices of 2020 led to postponed or cancelled projects for more supply. Higher prices of 2021-2022 were thought to get companies' managements to start to green light long-delayed projects, but the swoon in prices since April for almost all commodities has almost certainly delayed many discretionary projects. Commodities have been one of the hardest hit sectors of business by Chinese Zero-covid lockdowns and the concurrent rising concerns about recessions in the Western world. While we agree that economic slowdowns will certainly lead to lower demand and some pressure on commodity prices, we continue to contend that supplies of base metals like copper, nickel, aluminum and others are not sufficient to keep up with even current reduced world demand, depressed primarily by Covid lockdown delays/interruptions in China in 2022.

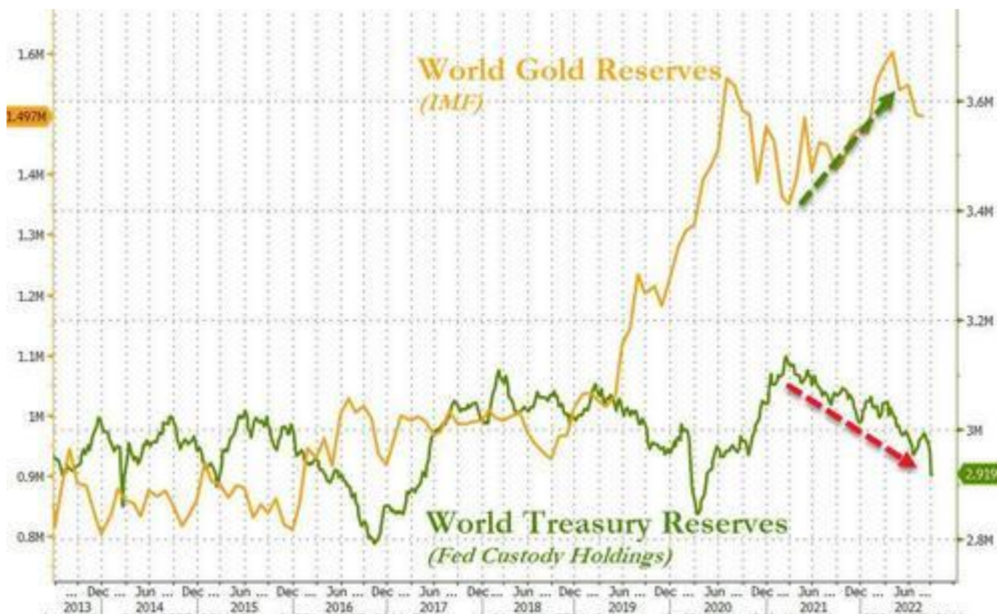
In addition, the needs of electric vehicles and electrification of more of our society (lithium, copper, silver, steel) are not produced in large enough supply today to even approach the goals set for the mid-2020s and 2030, much less the more aggressive goals of 2045-2050.

Finally, although it is not discussed as much as we thought due to this highly charged political environment, we think reshoring (or at least "friend-shoring" in Mexico) will lead to large amounts of demand for industrial building materials, automation equipment, industrial materials and energy grid infrastructure that will require large amounts of materials which will tax current North American sources. Combine that with the fact that Russia/Ukraine/Belarus and others affected by Eastern European hostilities produce large amounts of these materials for the world, and boycotts and logistical problems may limit supplies for the world from this region. Thus, we think there is a multi-year (maybe decade-long) need for developing new supplies for these developments.

Thus, we continue to like base metals mining and production companies producing copper, lithium, iron ore, coal, nickel, tin and rare earth minerals, and, with the large increases in money supply, precious metals and precious metals miners.

Precious metals hit new highs earlier this year but dropped significantly since April. While many investors are at a loss to understand what happened and what may in the future, we believe that the sudden closure of China, a large buyer of precious metals, in April led to traders selling during the spring/summer. Meanwhile, the strength of the US dollar, which was not as impactful earlier due to plenty of demand, continued to climb during the summer/fall, putting more pressure on precious metals (and base metals and agriculturals, etc.) by making them much more expensive for all non-dollar buyers, including India (the other large buyer of precious metals throughout the year beside China), further hurting demand. It now looks like the dollar has topped, as the Fed has started to give off signs of moderating their interest rate raises, taking away the main headwind to higher commodity prices, and metals prices in particular.

World central banks have noticed the lower price of gold in the past two years, stepping up their buying despite higher prices than in the mid-2010s. As shown in the Zero Hedge article, "Foreign Official Entities Dumped Stocks, TSYs In August As De-Dollarization Accelerates" by Tyler Durden on 10/18/22, world central banks have bought gold to have a multi-decade high in gold reserves while they have been shedding US Dollar reserves over the same time period. We see this trend continuing as the US becomes more involved in geopolitical events and countries try to insulate themselves somewhat against dollar movements, and US diplomacy spreads out to monetary policy (the US confiscated Russia's large monetary hoard at the IMF in March 2022 due to Russia's attack on Ukraine).



Fred Hickey, in his November 2, 2022 issue of The High-Tech Strategist, "The Waiting Game Continues," presents other fundamental supports for the precious metals markets: the World Gold Council (WGC) reported that central banks bought a record 399 tons of gold in the third quarter alone (when prices were depressed) and year-to-date (through September), they have bought 673 tons, "already more than the total purchase of any full year since 1967." And these numbers don't include any purchases from Russia or China, who do not report their purchases publicly. Thus, this inflationary environment has caused world central banks to buy the most gold in decades. In addition, Hickey

relates that the Reserve Bank of India reported that silver imports into India are near their highest ever, with amounts only through September. Indian silver imports are almost certainly going to set an all-time record, putting more pressure on silver prices around the world.

Thus, we continue to like precious metals for their protection against monetary authorities/central banks and the expected return to easy money policies. The US and world economies have so much outstanding debt, run up future obligations and have gotten used to low interest rates that we continue to believe central banks will return to more accommodative policies as soon as they can, even if it means allowing inflation to run at 3-4% instead of their present 2% target. This will again play to the strengths of owning precious metals and PM miners.

Finally, we think there continues to be a case for owning agricultural companies. The high price of natural gas around the world has led to much higher fertilizer prices, which, in many cases worldwide, has led farmers to use less fertilizer than in years past. While this may be okay for this year (or may not), it also probably leads to lower yields, which lowers the total amount of food produced and could make the world draw on food inventories, which would put further pressure on prices.

The continued high price of energy, due in part to underinvestment for the past few years, and especially lately in the US, means that food prices will not fall significantly in the near future. This is because energy is used to produce agricultural products: the energy supplies needed to produce/harvest raw food supplies, energy needed to run food processing facilities and, of course, the amount of diesel used by trucks to move the food throughout the whole process and ultimately to food stores.

Bottom line:
We continue to hold metals mining companies, both precious and base. We continue to own and look at adding exposure in attractive agricultural companies, including trading/processing companies, fertilizer companies and other value-add businesses. Attractive supply/demand fundamentals in the short, medium and long terms point toward these being multi-year holdings.

Summary

The US and other Western world economies continue to fight inflation but are starting to ratchet down that fight as economies start to show slowing demand, moderating economic activity and some weakness in certain sectors. Classic recession indicators like an inverted yield curve, lower leading economic indicators and high energy prices point towards a continued slowdown and almost certain recessionary conditions for 2023 and possibly longer.

Rising interest rates, geopolitical turmoil and a saturation of products and services post-pandemic point to lower corporate earnings in the future, while inflation continues to erode purchasing power of consumers worldwide. These conditions point toward a poor environment for growth stocks, especially those that still have high valuations. Companies that produce more essential products and those which have not kept supplies in long-term balance with demand will show better results and perform better in the stock market. We believe those will be more of the value stocks, and we continue to like the prospects for many companies in the energy, pharmaceutical, industrial, defense and commodity industries.

As the Fed slows down its aggressive interest rate hiking, persistent inflation will probably continue to favor stocks over bonds. Bonds will continue to worry about too-high inflation, while interest rates will probably stay sticky to the upside, limiting the amount of opportunity and eroding the safety that bonds have afforded over the last few years when inflation was much lower.

The dollar appears to have topped out, but it is probably not falling fast, meaning having US-centric stocks with continued minimal Chinese and emerging markets positions will probably be favorable. Until Europe resolves its energy situation and simmering authoritarianism of the EU over individual governments, European companies will be less attractive than companies in the Americas.

We continue to want to emphasize the themes of North American reshoring and self sufficiency of supplies, so many of our current and future investments will incorporate these ideas.

Kanos Quarterly Commentary

Ask the Portfolio Manager

We try to have a section at least once a year that addresses many of the questions we get in conversation with our customers. Here is our latest.

Are we in recession or not, and does it matter?

In our investment process, it probably does not really matter. In our minds, we think that the acknowledgement of recession could be important by how those in charge react to it. In most cases, that means a fiscal response from the government (usually not very helpful economically, except for the party-in-charge's supporters) or a monetary response from the central bank (generally helps most businesses, financial institutions the most, though).

In general, either the central bank (the Fed) or the government will react when recessionary conditions start to form, and acknowledging a recession is used to add more "aid" to the economy. It obviously would matter if the government and/or central bank won't acknowledge the coming economic weakness, which we have seen lately. It has resulted in the lowest stock prices in years (excluding the Covid lockdown shock in 2020) and a government that lost some of its power after the 2022 midterm elections.

What's the deal with employment? If we are in or near a recession, why is employment so strong?

We believe that Covid and US lifestyle changes over the past few years have resulted in employers consistently finding it difficult to find and hold on to good employees. So, we think that companies are "running heavy" in this weakening economic environment because they are cash flush from the past

couple of years and feel like the extra cost of a larger staff is more economical that losing business due to low staffing and paying historically high costs to try to replace former employees when business returns. Finally, we believe that business is not able to run at peak efficiency as it did in the 2000s and 2010s due to broken/frayed supply chains, falling globalization and the recent failure of just-in-time sourcing that must yield to a much more robust inventory management for business supplies and materials.

Why the recent underperformance of commodities, especially in light of their outperformance earlier in the year?

We think commodities have been hit with three short-term negatives: 1) they've been up since mid-2020, so there are investors/traders taking gains and looking for "easier" opportunities for trading profits, 2) China instituted their Zero-Covid lockdowns that continue in many places to this day, pushing down Chinese demand for everything, especially commodities, as their economy runs at constrained levels, and 3) the perceived onset of recession in the US and Europe, as economic statistics such as consecutive negative GDP readings and an inverted yield curve signal slowing. While we understand that all of these issues matter, they have already been discounted by the market, while the structural mismatch of supply and demand, even slightly reduced demand, has not been factored into the pricing. We think that supply issues will continue to crop up, and prices and commodity industry activity will build back to levels seen in the last couple of years and higher.

Why have technology shares underperformed? What are their prospects?

Technology companies benefitted from expanding market share, cheap financing and large amounts of sales growth over the last few years as traditional advertising and news flow moved online and was dominated by the FAANG companies and other social media companies. This large migration has mostly occurred, meaning that the large amounts of growth won't recur. This concept is best illustrated by Meta Networks (the old Facebook), which is seeing its flagship Facebook platform become a mature, zero-to-negative growth in users' business, Instagram showing slower growth, and their new focus, the Metaverse, not really catching on at this point. Going from +/- 50% user growth type numbers to essentially zero user growth means: 1) your earnings growth slows, 2) investors bid down your multiples and 3) your profit margins often drop as you build for growth but instead get no-to-low growth. Meta has exhibited these symptoms most acutely, but Netflix has also seen subscriber growth fall to near zero and even go negative earlier this year. Google (Alphabet) and Snapchat have seen ad growth fall to near zero. Microsoft has seen their PC business come back down to near zero growth after a huge bump during the pandemic. Amazon has seen its growth engine, AWS, slow down abruptly while sales at its flagship retail site continue higher but with very low margins. All of these businesses show maturing, with slowing growth and falling profit margins. It was no wonder that these highly valued companies fell in price. Apple is the best performer, having only shed about 15-20% of its value this year, but even Apple is cutting iPhone production and has suffered from abrupt falling sales of PCs, just like Microsoft.

The question now is: how do they re-establish growth? Do they come up with new initiatives (Meta), try to push forward on their traditional businesses (Microsoft, Amazon, Netflix), or some combo (Google). Does Apple have a new product up its sleeve? These questions are not often talked about by investors, but they are essential if these giants are to reclaim their former glory. So far, none of these questions have yielded answers that have satisfied investors enough to slow down their selling of these mega-caps.

Have any recent developments changed your thoughts about the future?

There are a couple of very important happenings that have occurred in the last couple of months that we think will really impact investment markets going forward:

The blowing up of the Nordstream pipelines – while this has not been covered as completely as we believe it should have been (maybe because who and why it was done is shrouded in mystery), we believe it was a watershed event: it permanently cuts off the ability for Germany to try to seek a separate peace with Russia over energy. It weaves together Europe, and solutions have to involve all of Eastern Europe and Ukraine. While the Western narrative says Russia did it, to us it seems obvious that the US/UK/NATO countries did this to keep the alliance together. However, it will probably ultimately cost the Western alliance hundreds of billions of dollars of extra money for energy by taking these pipelines out of service. And finally: it was the first large operation that destroyed energy infrastructure for strategic reasons. We don't believe it will be the last, and so current energy infrastructure becomes less secure but more valuable after this occurrence.

The cut off/isolation of the Chinese semiconductor industry – President Biden ordered that a large number of semiconductors, parts and processes be banned for use by Chinese companies in October. It immediately caused a large number of foreigners (many Americans but many others too) to quit their jobs in China and return to the West. It also prohibited any sales, manufacture or transfer of parts or technology to China going forward on most semiconductors. We believe this is the biggest "gun" fired in the economic war between China and the US/Western World, and that this one will hurt China immensely. China has been trying to develop a semiconductor industry quickly, ever since its flagship telecom/technology companies, ZTE and Huawei, were determined to be Chinese state actors that were then excluded from use around the world, and technology transfer to China was starting to be limited. China immediately knew they needed their own semiconductor industry if they were going to keep up in AI, robotics, space exploration and exploitation, etc. This cut off from Western technology, before they were able to really set up their industry, is probably a death blow to them keeping up with Western advances, and as one of their centerpieces, almost certainly really angered the Chinese leadership. It might even be called an economic Pearl Harbor, but we will only know that from events in the future.

As talked about above, we also think the recently finished Chinese Communist Party Congress changes doing business in/with China appreciably. President Xi's asserting his power, replacing the rest of the globalists from the 2002-2012 regime with loyalists, and consolidating his power while de-emphasizing outside contact and cooperation means that the Cold War with China is real and getting worse. We believe Chinese companies are now uninvestable, with the Chinese government potentially being involved with their companies but also the government's penchant for limiting business opportunities and having to "share opportunities" with non-shareholders, a sure way to have capital flee from China. We think that the Party Congress has shown the world that "China is Closed for Business" or that they will only do what benefits them, whenever they want, regardless of the rules, law or contract structure. This was being done before, but now it is virtually official and can happen to the biggest Chinese companies, and thus, to the biggest international companies doing business in China.

Finally, the UK pension crisis, also mentioned above. We think that the Gilt crisis which hobbled a number of UK pensions was ultimately caused by investment pools having to deal with extremely low interest rates (or in many cases, negative interest rates) while still having to provide traditional payouts to their pensioners/retirees. We think there are other problems located in pension funds that also have set payouts but were unable to earn those during the period of low interest rates; almost certainly, other

managers were forced to take risks with products that will show losses (or possibly worse – collapses?) as interest rates normalize up to 3-5% from 0% (and negative) rates. This will ultimately force central banks to ease and intervene again, but those are thoughts for another day.

What's up with cryptocurrencies and did the problems with FTX have any major ramifications?

We believe the trouble around the FTX brokerage is a big deal, further hobbling a crypto industry that was already suffering from falling prices and evaporating interest.

FTX is a brokerage company that executed trades for customers. The company's CEO, Sam Bankman-Fried, also ran a hedge fund called Alameda Research that acted as the main market maker around cryptocurrencies traded on the FTX platform. Alameda traded many cryptocurrencies and took speculative positions in companies and loans to other companies, with a lot of leverage. FTX was the more boring business that just took customer deposits, executed orders for customers when they wanted to buy or sell cryptocurrencies, and tried to promote new cryptocurrencies for customers to buy, sell and trade. Essentially, ownership in FTX was represented by tokens, which were called FTT tokens. The owners of FTX held large amounts of FTT tokens, with Bankman-Fried holding the most. In fact, Alameda Research, the hedge fund, used FTT tokens as collateral for some of its loans it used to leverage its bets.

Bankman-Fried used his position and the money that Alameda and FTX generated to become one of the most familiar faces in crypto worldwide, and he was one of the main industry participants in dealing with the US government, trying to get regulations for cryptocurrencies but in a light-handed manner. He also promoted FTX by getting a number of celebrities to participate, including Tom Brady, his then-wife Giselle Bundchen and Steph Curry, among others. He also signed up FTX for 20-year naming rights for the Miami Heat basketball stadium in Miami and had the FTX logo on all Major League Baseball umpires' uniforms for the 2022 regular season and playoffs.

As cryptocurrencies fell throughout 2022, Alameda's bets started to lose money, and it's now known that Bankman-Fried borrowed money from FTX to "tide over" Alameda's balance sheet temporarily. As things got worse, he "borrowed" more and more money from FTX's customers, without their knowledge, to pay for Alameda's losses. As smart people in the industry realized that Alameda might be in trouble and that the Alameda/FTX "Chinese Wall" might not be ironclad, some people started to act. FTX's larger rival and part owner, Binance, and its CEO Changpeng Zhao, decided that FTX might be in trouble, so they decided to sell their FTT tokens, representing their ownership in FTX.

Binance's dumping of a large amount of FTT on the market caused a "run on the bank" for FTX. They could not redeem or find buyers for a large block of FTT, and the value plunged 95%. FTX turned to Binance for a buyout, but after looking at the books, Binance backed out of the tentative deal. It was then revealed that FTX only had about 10% of the customers' money left; Bankman-Fried had "borrowed" the rest for Alameda's losing bets, and Alameda was bankrupt. In mid-November, FTX and 130 of its worldwide entities filed for bankruptcy, including Alameda. To add insult to injury, of the approximately $900 million of customer funds/assets left in FTX, $600 million+ were still in cryptocurrency form, and approximately $450 million of those were hacked on November weekend, leaving the almost 1 million customers able to expect 5% or less of their funds back after bankruptcy.

The company is domiciled and run out of the Bahamas, so US jurisdiction is tricky but probably going to have a lot of influence on what is ultimately going to happen, both civil and criminal. Bankman-Fried is a US citizen, and FTX had a large US brokerage arm, so there is definitely plenty of reason to have US influence over how the legal parts are handled.

But the FTX story is important for a number of reasons:

1) FTX was essentially unregulated in many ways, but it operated the way regulated brokerages do business throughout the rest of the world. Customers were at risk of loss without the protections given to traditional investors at brokerages in the US, Europe and many other countries. **Bankman-Fried wounded the cryptocurrency industry badly by raiding customers' funds because of the losses at Alameda, and peoples' trust in unregulated brokerages like FTX, Binance and many others will be wounded or absent for many years because of his misdeeds.**

2) Bankman-Fried made himself one of the most famous faces of crypto. Thus, his misdeeds now reflect on the whole cryptocurrency industry, tainting it for possibly a long time.

3) People have lost money on their positions, which many can accept, but his looting of customer funds, who thought they'd been "on the sidelines" and "safe" are completely unacceptable, and if customers weren't already angry, they are now. The stealing of funds of hundreds of thousands of small investors by a mega-billionaire sows further discontent about crypto-currencies.

4) Easy money policies, multiplied during Covid lockdowns, led to a ramping and huge interest in cryptocurrencies. Higher interest rates, quantitative tightening and huge losses in the value of cryptocurrencies themselves and crypto businesses will only lead to a waning in interest for crypto for the next several months and years.

5) The losses on cryptocurrencies themselves, while large, are probably able to be contained without any financial contagion because many financial institutions considered them speculative and thus not of substantial value. However, loans to companies and "collateralized" loans to traders are much more traditional, so losses may occur at more traditional lenders who say the rapidly growing industry as a place to grow one's lending business. If so, there could be financial fallout in traditional financial institutions, especially with central banks raising interest rates rapidly during 2022. Bankman-Fried himself is said to have lost on the order $30 billion, and FTX/Alameda are only part of the complex. Combine that with Bitcoin going from $69,000 down to $16,000, and there may be some more financial damage to be revealed.

6) And finally, any light-handed regulation that may have been in the works for the cryptocurrency industry is almost certainly to be scrapped for more restrictive regulation. The free-wheeling days of the crypto craze is now gone – for it to grow, people are going to demand some oversight and some protections against a "Bankman-Fraud" happening again. This will change the cryptocurrency industry forever – it was conceived as an industry "outside of the banking system" but now people will abandon it because it doesn't have the protections of the banking system.

The Managers of Kanos Capital Management

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