KANOS
CAPITAL MANAGEMENT, LLC

Second Quarter 2023 Investor Letter

Second Quarter Market Review

Looking back at the second quarter of 2023, US equity markets continued to rally, bond yield fell somewhat from decade highs, and inflation started to drop but remained at a high level. Expectations of recession increased in June, leading many energy, industrial and commodity stocks to swoon. The Fed's March 2023 US banking crisis bailout, continued large Japanese quantitative easing and strong US government spending (without debt issuance during the debt ceiling crisis) combined to provide significant additional liquidity into world financial markets, most notably the US stock market. The artificial intelligence (AI) frenzy combined with green energy enthusiasm led to concentrated buying in large cap companies in the technology, consumer discretionary and communications sectors, pushing those sectors and the overall market to multi-month highs. Most other stocks, including most value stocks, were excluded, leading to many sectors giving back first-quarter gains. Many economic statistics, excluding employment, continued to show weakness, proving growing weakness in the US and other world economies. The debt overhang caused by June's resolution of the debt ceiling crisis, along with the Supreme Court ruling against student debt forgiveness, weighed on many market segments late in the quarter.

The majority of Kanos portfolios were mostly flat during the second quarter as value stocks and commodities slumped and then recovered later in the quarter. Similar to the universe of stocks, Kanos portfolios had many stocks on either side of unchanged. Larger holdings included winners: Merck (+9.2%), Microsoft (+18.4%) and ConocoPhillips (+5.6%) and losers: ExxonMobil (-1.4%), Agnico Eagle Mines (-1.3%), Kayne Anderson Energy Infrastructure (-3.5%) and Newmont (-12.1%). Most energy producers recovered to post small gains while miners faded to post losses. Some more speculative holdings bounced back, like CRISPR Therapeutics (+24.1%), Rare Earth Minerals ETF (+1.9%) and Lithium/Battery ETF (+2.3%) [these were down most of the quarter].

Markets worldwide performed well during the quarter but had narrow leadership, led by the AI-crazed Nasdaq with a +12.8% gain, while the S&P 500 gained +8.3% and the Dow Jones Industrial Average moved up +3.4% (all performance numbers reflected total returns). Sector performances were all over the map, with a gush of liquidity pushing up the past bull market leaders, including Technology (+15.4%), Consumer Discretionary (+13.9%) and Communications Services (+12.5%). Most of these stocks were rebounding from 2022's -33% Nasdaq drop. The quarter's losing sectors included Consumer Staples (-0.1%), Energy (-1.1%) and Utilities (-2.5%) (again, all performances reflect total returns) which were the best performing sectors in 2022. Fixed income markets were less volatile than past quarters but were lower, with both governments and corporates showing quarterly losses of between -0.5% and -1.0%. Bond yields rose (adding to 2022's -13% losses), with the 10-yr US Treasury bond ending at 3.81% while the widely watched 2-yr Treasury note ended at 4.97% and the 3-month T-bill was at 5.43%. Many foreign stock markets rallied during the quarter: the Japanese Nikkei 225 was up 18.4%, Brazil's Bovespa gained 15.9% and India's Bombay Sensex was up +9.7%. The US Dollar rose +1.3% during the quarter, and the stronger dollar hurt commodities and

1217 South Shepherd
Suite 200
Houston, Texas 77019
www.kanoscapital.com

foreign currencies: many dropped for the quarter with gold down -2.4% to $1,921/oz while WTI crude oil dropped but seemingly bottomed, ending the quarter down 6.7% at $70.64/bbl.

Looking Forward

Introduction

Impact of Interest Rates on the Economy – It takes time for monetary policy changes to effect growth and inflation in the economy. Currently, US headline inflation has come down significantly, from 9+% to 3+% in just over a year, after having run up after Covid lockdowns over eighteen months. Core inflation has come down more slowly, however; it currently is just under 5% on an annual basis. The Fed has been raising interest rates to deal with the abovementioned inflation, and it is trying to slow the economy and tamp down the post-Covid speculative fervor without causing a recession. In spite of 5% of Fed tightening over the past fourteen months, a recession has not occurred, mostly due to a combination of oversized US government spending and companies' reticence to lay off workers (which were so hard to find post-Covid). The current situation, with rapid Fed tightening and falling inflation but at least some economic growth still occurring (the Blue Chip consensus for Q2 2023 GDP growth is just 1.2% annualized) has cause many in the financial markets to state the economy is and will be experiencing a "soft landing," and thus, they expect the Fed to pause after the anticipated late July rate hike, dropping rates starting in early 2024 to help reignite economic growth after this most recent economic slowdown. They reason that since 2008 (and really since 2003), the Fed has lowered rates to help the economy reaccelerate, and that in turn helped push up the stock market through these easier money policies, but inflation hasn't been a factor in many many years. Now, with inflation higher than the Fed's target and the Fed committed to taming it further, they have pledged to keep rates high, for at least 9-18 more months, which will keep pressure on our financially-oriented US economy. And inflation may not drop appreciably further due to the "base effect," where higher prices from prior periods make deflation temporarily higher (just like inflation spiked early last year), but now rising food and energy costs look to stop falling, which will temper further disinflation like we've seen recently. Many economic statistics also show faltering growth, so the Fed is between a rock and a hard place, trying to slow inflation but not kill the economy.

The Fed hasn't had to fight strong inflation and inflationary tendencies in over 40 years (since the late 1970s/early 1980s), so the experts (and markets) don't remember how much time it takes for inflation to be rooted out. We believe inflation will surprise to the upside in its stickiness due to continued strong government spending and stimulation as always happens in the year before elections. We also think that the Fed will have to "fold" if there is any kind of further crackup in the financial markets or financial system (witness the bank failures of March 2023 and the immediate large Fed stimulus). With the Fed continuing its multi-month rhetoric of "higher rates for longer" mantra, we think that higher interest rates will continue to slow the economy but fail in their attempt to get the inflation "genie back into the bottle." With slowing growth and continued high interest rates, the high-valuation, large cap growth stocks that have benefitted from the anticipation of lower rates may see a correction in the near future.

How Kanos Portfolios are Positioned – Although we believe the US economy (and other developed economies) will continue to slow, continued government spending at a record pace will last into the 2024 election cycle, and see reshoring and the green/electrification buildout continuing for years, we

think there are a number of opportunities for our customers' portfolios. The Biden Administration has made electrification of America a priority, and their geopolitical actions have made reshoring a political reality for the US and North America. Combined with increased government spending on social programs, defense and infrastructure, the need for materials and energy to power these programs should offset somewhat the falling industrial activity we've seen in economic statistics lately. In addition to energy and metals, pharmaceuticals, defense, agriculture and "fallen angel" technology and biotech stocks should be attractive investments going forward. The underinvestment of the past 8-12 years in materials and energy, coupled with a renaissance of new developments in both biotech and more traditional pharmaceutical pipelines provide a fertile hunting ground for less picked-over sectors. And with second quarter weakness in many of these sectors, we believe a large chunk of any economic slowing has already been discounted by the stock prices of these more prosaic industries. Bonds have less appeal for us because of uncertain liquidity going forward, large refinancing needs by governments as well as highly levered industries and sticky core inflation. This combination makes bonds less attractive to us. The US dollar is going to suffer for these same reasons, so we would steer clear of cash and dollar-denominated debt in the intermediate- and longer-terms.

Many tech stock prices, even after the 2022 dip, have valuations not seen except at bubble tops like 2000, 2007 and 2021 because of the presumed going forward environment of reversion back to lower and falling interest rates, government and central bank stimuli and falling inflation. However, these conditions are temporary – the Fed's continued pledge for high interest rates, their continued usage of quantitative tightening (QT) that lowers financial system liquidity as they shed bonds from their balance sheet and what will prove to be an incomplete battle versus inflation mean the valuations of these formerly high-growth stocks will almost certainly be reset lower once more, when we will be attracted to them for their more reasonable valuations. US stocks are bifurcated into expensive/very expensive growth stocks which many investors believe are recession/higher rate resistant, while most other US stocks have been treated like we are entering a recession presently. As state above, we are interested in being invested in the sectors we believe will provide a better risk-adjusted return than the currently popular high fliers. These points are all covered in detail in the respective sections below.

At Kanos, our job is to grow our clients' portfolios over time, to preserve value during bad times, and earn income so clients can enjoy their lives and their treasure. We are always looking for real growth prospects that have reasonable valuations for their potential and will perform to get to get to that potential in a reasonable investment timeframe.

Economy

The US economy continues to bump along in a slow growth environment with moderating inflation but strong labor conditions, meaning the Fed is still talking about further rate hikes and trying to slow the economy further to squelch inflationary impulses back to its target of 2% inflation and lowered inflationary expectations. It also continues its program of Quantitative Tightening (QT), attempting to shrink its balance sheet and dampen financial speculation through decreasing financial market liquidity.

As in many recent instances, soft data led by the purchasing managers' index surveys (PMIs) and the Institute of Supply Management (ISM) surveys, as well as many of the regional Fed reports, continue to paint a picture of slowing manufacturing while services have seen some slowing but continue to show pricing power and thus sticky inflation. Thus, manufacturing could be considered to already be in recessionary or near-recessionary conditions, while many service sectors continue to have steady

business, and many are still looking for workers. Housing has been the notable standout, with few houses for sale and multi-family rental units still exhibiting demand, keeping prices high and shelter inflation rising, while single family homebuilders continue to see surprising demand. This is one of the challenging issues for the Fed in tackling inflation.

Inflation has continued to drop in the short-term as "base effects" (where levels compared to a year ago are already expected to show disinflation, thus "baking in" a lower inflation number, with the most notable example being lower energy prices) continue to push down reported inflation. The most recent inflation report for June showed headline inflation down to 3.0% y-o-y, but core inflation, excluding food and energy, continued to show still-high inflation of 4.8% y-o-y, although most measures are growing near-term at near Fed inflation target levels. We believe continued strong government spending government programs like the Infrastructure Act and the contrarily-named "Inflation Reduction Act' with its green infrastructure initiatives will contribute to drive demand for materials in the US and worldwide, further adding to inflationary pressures.

The banking system, all of a sudden seemingly shaky in March after three large bank failures, has not recovered but has stabilized enough to keep out of the headlines. However, since interest rates are near the tops of their recent ranges, banks with large bond and loan portfolios continue to suffer losses if they have to sell any financial assets, leading to a dearth of any deals being done in the banking system presently. This also has effects in commercial real estate, where some banks own large commercial mortgages, and as some of these have come due, the borrowers have handed the mortgaged office buildings (and to a lesser extent hotels and malls, like in downtown San Francisco) back to the lenders, forcing them to recognize losses. This looks to be a growing problem, so we will stay tuned and see if this starts to resemble the RTC problem of the 1980s, when failed banks were seized by the FDIC after failing and real estate values were affected by the subsequent auction of bank-repossessed real estate.

Developed economies, especially the UK and western Europe, have shown growth this year but also persistent inflation, leading to recent rate hikes by the BOE and ECB, respectively. They have been taking cues from the Fed; however, many market participants see these central banks as nearly done with their rate hike cycle, much like they see the Fed currently.

Asian economies have reacted in different ways to recent economic forces. China has seen consumer activity rise as the end of Covid lockdowns have allowed people to travel (finally) while also lessening domestic industrial activity, dampening post-lockdown growth to low single digits and causing both exports and imports to grow only sluggishly, as reflected in low, nearly-contractionary ISM and PMI business surveys. Australia has mirrored Chinese activity, seeing economic growth ease off as demand from China fails to reach pre-Covid levels. South Korea has also seen some slowdown in its economy, as best reflected by Samsung's recent earnings statement, where profits were down 96% from the year before. Inflation is still present in Asia, but like in the US, inflation is slowing down as demand fails to reach 2019 levels.

Meanwhile in Japan, since inflation was still relatively low compared to the rest of Asia, the Bank of Japan (BOJ) has kept their yield curve control (a form of QE) going, providing further liquidity and jumpstarting economic activity, leading to higher economic growth as reflected by a Nikkei stock market average at multi-decade highs.

Bottom line: US economic statistics show the economy seems to continue to slow, while certain industries and pockets of strength, like housing and employment, continue to stay strong, despite the late cycle timing of economic growth.

Equities

Liquidity in US (and to a lesser extent world) markets has increased lately, which has fueled recent stock market and spec asset appreciation. Not only has QT been nullified by the liquidity provided to banks and depositors during the March bank failures, thus providing a sudden slug of excess liquidity, but the Fed's new program for suffering banks provided an additional source of funds. This Fed "line of credit" for banks has a current 1-year life, and its usage has grown each week, again nullifying the Fed's attempt to rein in liquidity and slow the US economy appreciably. With creditworthiness falling in the consumer economy, the financial system has provided this liquidity to financial market players instead. In addition, the late May/early June debt ceiling showdown allowed the Treasury to virtually empty its cash account to pay the government's bills, but could not borrow (until the deal was agreed to and signed into law in mid-June) – this spending without funding served as a large sudden source of stimulus that the financial system channeled to its most voracious customers – banks, brokerage and other financial intermediaries that lent it to large institutional customers, who leveraged the cash on their balance sheets to push up the stock market into July.

The sudden emergence of new AI products has led the market since May, with tech, communications, industrial and services firms all feeling the need to mention how their companies are incorporating AI into their processes and operations, leading investors to pour more money into these companies, which are mostly (40+) large tech companies, broadening the tech rally slightly, but not including many other sectors.

While there are exciting new products and processes using AI, it is not new or newly utilized. Fred Hickey in his High-Tech Strategist newsletter "2000 Déjà vu" from June 1, 2023, describes it like this: "AI is not new…*Forbes* ran a cover story titled "The New Face of Artificial Intelligence…in 1988…Nvidia is the primary beneficiary of the current craze…Lots of tech companies must show they're involved in AI – so they're buying loads of very expensive NVDA graphics chips and boards that's led to surge in orders for NVDA…Despite the recent spike in interest, Nvidia has been working on AI since the early 2000s and their CUDA AI software platform has been around since 2006. IBM's Watson AI was supposed to revolutionize the world when it was released in 2011[, but] Watson's been a major failure and loss-leader for IBM for over a decade. AI is already embedded in everyday life. Apple's Siri uses AI. So does Amazon's Alexa. All the driver-assist programs and self-driving features in newer cars are AI-based. Manufacturing floors are loaded with AI-based applications. Looking for answers on your phone from your bank, broker or PC maker? – you'll get a response from a computer [already] using AI." So AI is not new, newly available or a particular source of revenue, except for chip makers and software developers, crunching the massive amounts of data used to form the rules for modeling behaviors.

As anyone who has been following the US stock market recently has probably heard, the market has been propelled by only a handful of mega-cap stocks, and since the major averages (except for the Dow Jones Industrials) are capitalization-weighted, mega cap stocks can move the market with little to no help from other stocks. So most stocks and many portfolios are not having the performance year that loading up on expensive tech stocks might show. We are examining how expensive many tech stocks

are in the Kanos Commentary titled: "Valuation Matters…When Most Least Expect It" at the end of this letter. With core inflation still hundreds of basis points higher than the Fed's target, and the Fed saying repeatedly that they were going to continue to raise interest rates at least twice more, the market looks expensive currently at approximately 19x forward earnings.

In a June 21, 2023 ZeroHedge article titled "Goldman Offers 5 Reason To Start Hedging The Equity Melt-Up," the article presents a table prepared by Goldman Sach's Global Research team that shows a number of valuation metrics for both the S&P 500 index and the median stock in the index, both of which are on the very high side historically. In the table presented below, and you can see that the S&P 500 index, when all the metrics are compared, the median metric is in the 90th percentile, even after the big correction of 2022. The median stock is actually more highly valued, at 94% of the historical range of valuations. While overvaluation is a "condition," not a "signal," i.e. overvaluation isn't going to change just because we noticed it, as research guru Tom McClellan of McClellan Research has often said. However, bull markets usually start when valuations are low, because investors in aggregate have sold and buyers find bargains. In this case, it seems like we are back to a condition where there are more buyers than sellers, but that could change quickly as bargains are harder to find and liquidity continues on a course to tightening.

Exhibit 4: S&P 500 valuations are elevated vs. history
as of June 15, 2023; historical data since 1974 except forward P/E (1976), cash flow yield (1987), FCF yield (1991) and yield gap vs. IG (1998)

	Aggregate index		Median stock	
Valuation metric	Current	Historical %ile	Current	Historical %ile
US market cap / GDP	232 %	97 %	NA	NA %
EV / sales	2.7 x	96	3.1 x	96
Price / book	4.4 x	92	3.3 x	94
EV / EBITDA	13.5 x	92	13.5 x	95
Cash flow yield (CFO)	6.2 %	88	5.6 %	NA
Forward P/E	19.3 x	88	18.0 x	89
Cyclically adjusted P/E (CAPE)	27.7 x	88	NA	NA
Free cash flow yield	3.6 %	61	3.5 %	64
Median absolute metric		**90 %**		**94 %**
Yield gap vs. real 10-year UST	368 bp	89	406 bp	80
Yield gap vs. IG	-29 bp	83	9 bp	80
Yield gap vs. 10-year UST	146 bp	74	184 bp	50
Median relative metric		**83 %**		**73 %**

Source: Goldman Sachs Global Investment Research

The Fed has continued to espouse its mantra of higher rates for longer, and after their recent June "pause" in raising interest rates, Chair Powell has said repeatedly that they will be raising at least two more times. In addition, the Fed's QT program continues to let Treasuries and mortgage bonds on the

Fed's balance sheet mature, shrinking their holdings and tightening overall liquidity. Finally, the Treasury has started to sell large amounts of debt since the debt ceiling agreement, taking liquidity out of financial markets (investors use cash to buy bonds) as the government bond sales refill the Treasury's bank accounts. These three factors: 1) higher interest rates, 2) QT and 3) increased Treasury debt sales are all dampeners of market liquidity negatively, which will impact the US stock market.

Having said that, we believe there are sectors that will attract available investment dollars due to improving fundamentals and recent underinvestment – those are the segments in which we currently have your portfolio invested. In recent months, recession fears have mounted and many consider large-cap tech resistant to recession, a lot of investment dollars have flowed to big cap tech, leaving most other sectors either side of unchanged for the year so far, temporarily underperforming the market "stars." We are invested in the following sectors because we think in aggregate they will provide a better risk-adjusted return than the currently popular high fliers. The following lays out once again our rationale:

A) Energy stocks – energy stocks far outperformed in 2021 & 2022 due mainly to the "catch up" trade of 2017-2020 underperformance, undersupply for the post-Covid reopening and the worries over energy disruptions due to the war in Ukraine. In 2023, energy stocks have underperformed due to investors rotation out of last year's winners and oversupply concerns due to what many consider a "too-slow" Chinese post-Covid reopening of their economy. Since energy underperformed every year from 2014-2020 (except one, 2016), we believe that investors' reflexive shift away from energy due to the 2021-22 outperformance is short-sighted (and frankly wrong, judging the fundamentals). As far as the Chinese demand story, private forecasters and now the International Energy Agency (the IEA) have both shown that April 2023 was China's largest usage of petroleum products in history, surpassing 2019 pre-Covid records. Just like others in the Western world, Chinese citizens are traveling post-Covid in greater numbers than ever before (post Covid lockdowns). Valuations are also attractive: the US majors and large exploration companies are selling for <10x P/E and forward P/E ratios, P/Sales ratios under 2x, and P/Free Cash Flow of most large US companies under 10x, with dividend yields from 3-6%. Very attractive and still conservative fundamentals, with the industry paying off debt and returning capital to shareholders. We still think energy is attractive, sustainable and essential, for countries around the world and for our investors. Recessions generally only shave 2-5% of demand off peak levels, and the underinvestment that has happened in the worldwide energy industry since 2014 virtually guarantees that current levels of production cannot be maintained anyway, rendering moot the oversupply questions of the current day.

B) Precious metals and mining stocks – the easy money policies of world central banks over the past decades have catapulted precious metals prices to multiples of their former prices. Gold had been pegged to the dollar from 1945-1971, but de-pegging caused gold to rise from $35/oz in 1971 to $850/oz in 1980. The current cycle's low gold price was $256 in 1998 while gold prices topped $2,085 just after Silicon Valley Bank failed in March 2023. The large fiscal deficits being run up by the US Government along with increasing geopolitical tensions of US militarism and Russian, Chinese, Iranian and other countries' increasing aggressiveness have led many world investors into safer investments, headlined by gold. In fact, world central banks bought the most gold for their own reserves in 40 years in 2022, and central bank gold buying has continued to be strong in 2023. The US is relatively unique in not having increased gold buying by institutions and individuals, as US investors have judged that mega cap tech stocks are a better haven for capital, although 2022 might have shaken those beliefs somewhat. Many expect the Fed to stop raising interest rates, but lower interest rates and a return to easier money would probably push more capital to safe havens like gold and silver than very highly valued tech stocks (see our discussion below in the Kanos Commentary). Thus, we have invested in gold and silver ETFs and

more so in in precious metal mining companies. Valuations are attractive: our two biggest holdings, Agnico Eagle Mines and Alamos Gold, have shown growth in Past 5Y Sales (+20.7% and +5.6% respectively), Past 5Y EPS growth (+8.1% and +1.8%), while expecting growth in Next 5Y EPS (+0.1% and +7.0%). Currently they trade at 1.2x and 1.3x Price/Book ratio, and both pay dividends (3.3% and 1.1%). Both have expansion plans in progress and already are in the lowest 25% of production costs. Our other holdings have similar attractive valuations. We believe the metals themselves and the companies that produce them will rise in price as well as valuation over time. In fact, the precious metals in July have broken their late spring downtrend and are already headed upward.

C) Base metals and base metal miners – Base metals, including copper, nickel, zinc, tin, lead and others (including technically iron ore) rallied in 2021-22 as underinvestment met the green energy revolution and plans for building a larger fleet of electric vehicles along with charging stations, energy transportation infrastructure and expanded renewable energy facilities met the limits of current supply and mine production. We believe the push for renewable energy infrastructure will continue, especially with so many governments providing subsidies, tax breaks and actual capital to continue the buildout, in addition to the need to upgrade and expand our current electric grids and distribution networks. All this needs a lot more copper, nickel, and even steel than is currently being supplied. Most big mines worldwide were found and developed prior to the 2008-2009 financial crisis, so the world has again underinvested in supplies at a time when policy makers and private companies have gotten used to plentiful worldwide just-in-time supplies of everything. This will need to be remedied through enhanced exploration and development of new mines and expanded old mines. We believe the base mining companies will be big beneficiaries over time. And a recession will not get in the way of governments moving forward with their green agendas, meaning the cycle will be less affected by cyclical downturn factors than in past cycles. In addition, Russia produces a large share of the world's base metals, and trade restrictions coupled with underinvestment due to continued heavy war spending, is likely to reduce availability and tighten supply dynamics. Valuations are attractive but show "lumpy" earnings due to the nature of mine development and production. P/E ratios are less than 10x for past and forward, Price/Cash Flow are 10-15x and dividends paid are 8-12% for the large multinationals we own like BHP and Rio Tinto. We also own a couple of US coal companies that trade for less than 4x both past and forward P/E and pay dividends as they export coal to energy-hungry countries around the world, led by China.

D) Pharmaceutical stocks – Pharma stocks have, for the most part, been far more "growth-y" than in the past as a new crop of drugs for cancer, obesity and a number of other maladies feed their bottom lines and research arms. Wegovy/Ozempic from Novo Nordisk has led the obesity drugs, but Lilly has a number of new drugs coming to market, highlighted by their obesity offering, that has led to pharma stocks great performances of the past few years. However, in 2023, most are considered boring safe havens (they all pay 2-4+% dividends (except Lilly) and have more consistent earnings but not the level of growth of growth stocks. But Merck's Past 5Y EPS has topped 25% as their Keytruda cancer drug has been applied to more and more types of cancers, while Merck, Lilly, Novo and AstraZeneca are expected to grow earnings by at least 8% for the next five years. Valuations are no longer very cheap, but with growth and pricing power still extant, forward P/Es of these companies are 12-17x (except for Lilly's 37x). We continue to like these for stability, growth and absolute returns.

E) Defense stocks – we owned defense stocks long before the war in Ukraine came along. We owned them for their reasonable valuation, the underinvestment by the western nations in defense in years past (which we felt needed to be increased) and because the need for maintenance of current technologies and the care and maintenance of new systems would be an excellent and consistent earnings stream for

these companies. We own Lockheed Martin and to a lesser extent Northrup Grumman; we have stayed away from Boeing and Raytheon/Honeywell due to their large civilian aerospace businesses which we thought were over supplied and poorly executed (see Boeing's awful record of poor safety and design over the past few years). Valuations are attractive, especially knowing customers are governments, led by the US Government, with no credit issues. P/E ratios are high teens for current and lower teens for future, P/Sales is under 2x and P/CF is generally around 25x, with dividends from 1.5-3.0%, depending on company. The need for keeping our military running and upgrading older systems means that well-run defense companies will benefit our portfolios, even with some cyclicality to their earnings.

F) Agricultural and ag products stocks – Agricultural companies have historically been an investment in companies that improve efficiency because we have gotten more and more out of our soil and equipment around the world as we've refined farming methods, incorporated lots of technology and used material, chemicals and improved seeds judiciously to increase yields to unimaginable amounts compared to the 1800s. However, deglobalization, geopolitics and resource nationalism have combined with 2023's El Nino weather phenomenon to make some ag companies interesting pieces of our portfolios. There are three main types of investments: 1) actual agricultural commodities themselves, in the form of an exchange traded fund that owns grains, etc., 2) trading companies that buy and sell the ag commodities and 3) companies in the ag supply business, like fertilizer companies or machinery companies. We own small quantities of all three: and all three have suffered this spring as supplies out of Ukraine looked plentiful. But lately, El Nino has shown its effects, causing droughts in some growing regions around the world, Russia has said it would quit the grain export truce with Ukraine, thus putting those supplies in harm's way and geopolitics in some other regions have led to limiting exports. Thus, valuations are very cheap, with current and future P/E ratios for fertilizer companies under 10x, sales expected to grow 10%-ish in the future, and their continuing to pay 2-4+% dividends too. Farm Products/Trading companies like Archer Daniels and Bunge have 8-12x past and forward P/E ratios, low P/CFs and have shown +/- 10% growth in sales in recent years and still pay 2-3% dividends too. ETFs don't pay dividends but rely on capital appreciation due to rising ag product prices, which have occurred over the past couple of years.

G) "Fallen Angel" tech and biotech stocks – with many tech stocks trading at valuations not seen except at bubble tops like 2000, 2007 and 2021 (post-Covid), we have looked for tech stocks with excellent medium-term growth prospects which may have development issues or are in depressed markets. Thus, we own stocks like AirBNB (depressed real estate and regulatory overhang from the pandemic means it trades at much lower valuations), Zillow (depressed residential real estate transaction markets and higher interest rates means views and deals, especially from "flippers," are down from Covid highs), Crispr Tech/Intellia/Editas are gene therapy development companies that could be taken over by pharma companies looking to develop "designer drug deliveries." It has not happened and these companies' developments have come slower and at higher costs than we thought, meaning these companies have lost much of their market cap, but their technologies are still viable and could lead to much higher valuations when consumers and regulators both feel comfortable with their future development and usage. We think all of these companies continue to have attractive growth prospects and are now at good risk/reward valuations for future appreciation or possible acquisition.

As we look forward, we see the chronic underinvestment in many of the above sectors leading to supply problems, which will provide pricing power to our producing companies while higher prices provide them with increased capital to invest in new properties and facilities. In addition, we think that the pharmas and biotech companies will continue to develop new pharmaceuticals and therapies that will

target consumer preferences, like the obesity drugs but also the designer drug therapies being developed by our gene development companies. But as we have spoken about above, higher interest rates will lead to recessionary conditions, which will squelch financial conditions and slow economic growth and almost certainly hurt currently high valuation growth stocks.

Developed country stock markets in general have benefitted from perceptions of better economic activity and easier monetary conditions (Asia, in particular). However, they have also benefitted from lower currencies (dollar was slightly stronger this quarter), but we see the dollar weakening going forward, so we are not sure the "more competitive currency" tailwind helps in the future. We do own some Japanese trading companies which are benefitting from a better domestic economy and from trading activity throughout Asia. Emerging countries have not benefitted as much – China is still classified as an emerging market, so "emerging market" stock pools are dominated by Chinese companies, which have done poorly this year. We like foreign commodity companies because they generally have lower costs (competitive currencies), less restrictive regulatory environments and, in many cases, bigger/richer deposits. However, we continue to be wary of resource nationalism, the tendency for local governments to help themselves to a larger portion of projects in their countries as prices of products rise / perceptions of supply grow tighter.

Bottom line: US stocks are bifurcated into expensive/very expensive growth stocks which many investors feel are recession/higher rate resistant, while most other stocks have been treated like we are entering a recession. We continue to feel that the monetary/debt conditions and supply/demand conditions point to the attractiveness of a number of value stocks, especially commodity-oriented companies, in spite of the onset of recessionary conditions, much of which have already been discounted.

Bonds

US bonds have seen their volatility drop since the first quarter of 2023, although yields have moved up as the Fed has continued to talk tough about raising interest rates at least twice more, in spite of a pause in raising at their June meeting.

US Treasury bond yields have been climbing in June and July as short-maturities are priced with higher yields, reflecting expected rate hikes later in the summer, while longer-term maturities (10s and 30s) dropped off in June, as bond investors price in a larger chance of recession, and thus, demand for long-term bonds.

Corporates, especially high-yield bonds, have performed better than Treasuries as these junk bonds act more like stocks and have followed up the stock market in performance. Investment grade corporates have outperformed Treasuries also; investors seem to think there's less of a chance for recessionary conditions to affect conservatively financed US corporations.

We still believe that the risks in bonds outweigh the rewards. The US Government is already refilling its cash accounts by issuing bonds, sticking mostly to T-bills as not to upset the bond market, but with up to $2 trillion in bond issuance needed to refill cash, as well as pay for the budget deficit and the current off-balance sheet obligations, we see a lot of pressure on market liquidity by the Treasury, pushing up yields and possibly crowding out some of the private debt needs. We are still leery of sticky inflation and how it may impact bonds on a longer-term basis, thus adding to their unattractiveness in our eyes. Having said that, as a place to stash cash or short-term obligations, money market funds currently yielding 5+%

are very attractive for current short-term income. But we don't see who will buy the large amounts of long-term Treasuries due to come to market later this year and going forward.

We see high-yield corporates as the pain point and are thus avoiding them. With current liquidity plentiful in the short-term – market commentators say that the large Treasury T-bill issuance has taken some liquidity from the Fed's "reverse repo" facility, where many money market funds had been investing their cash, thus not crashing bond market excess liquidity so far – high yield investors are enjoying the extra yields and capital appreciation these bonds have enjoyed this spring. However, some high yield issuers are facing refinancing in the next 18+months (allegedly as much as 25% of the high yield market), and a surprising number of companies will face hardship (or possibly bankruptcy) when markets with limited liquidity and wary of an approaching recession look at the prospects for a highly levered former LBO which has been scraping by on cheap financing and cost cutting to stay solvent. We see this as the canary in the coalmine for the onset of the recession – these companies will start to go bankrupt when they cannot secure financing at any cost.

Developed world bond yields have continued to mirror US rate moves, as foreign central banks, most notably the ECB, Bank of England and Australians all have raised interest rates again in May-June. Thus, rising rates and hawkish central bankers have led to a less-than-friendly bond market environment in Europe and Australia/New Zealand. However, continued economic sluggishness in China and continued easy money policies in Japan, as it continues with its yield control policies, have seen lower and steady interest rates in the largest markets in Asia, respectively. This could continue as both countries continue to stimulate their economies, unlike western central banks. We are not sure how long these Asian banks can maintain these policies, so we are not interested in investing there.

Bottom line: Bond rates have seen some dampening of their volatility, but uncertain liquidity, large financing and refinancing needs and sticky core inflation make bonds still unattractive to us. For allocations to cash, money market funds yielding around 5% are very attractive.

Currencies

The dollar rallied during the second quarter, reacting to the Fed's tough talk on continuing to raise interest rates (based mostly on labor tightness and continued strong labor reports), but it has given back all of those gains and dropped to a 14-month low after the debt ceiling issues were solved and the Treasury went back to large issuances of new bonds to pay for giant US budget deficits. In addition, many investors think the Fed is looking like it might be close to its last rate hike. This bearishness is at least somewhat offset by continuing expectations for Fed tightening and strong labor reports; many see inflation as sticky but still falling towards the Fed's targets, meaning it is not nearly the factor in rate decisions it has been for the last year plus. Thus, while we still see the dollar headed lower over time, we see factors which could support it at times this summer, and so we will not be taking short dollar positions, although many of our other investments benefit from a lower dollar.

The ECB continues to talk tough and has room to raise interest rates, but we are leery of the leadership. We see Europe as weaker overall financially, and subject to energy shocks due to the current potentially precarious energy situation with the war in Ukraine providing continued and potentially increasing uncertainty. We see any hiccup in energy supplies affecting European economies quickly, which we believe would cause the ECB to act faster than in the past, providing some kind (or many kinds) of relief (like their version of QE), which we believe would weaken the euro quickly and possibly substantially.

The yen has fallen all quarter as the Bank of Japan (BOJ) continues its past policies under new leader Ueda, which the market believed might change earlier this spring. But Ueda immediately announced the status quo would be in effect for at least the rest of 2023, thus the yen has continued its multi-year weakness, which has lit a fire under Japanese equities, if nothing else. We believe the BOJ will be forced to support the yen and fight budding inflation, but the timing is impossible to ascertain. Thus, we continue to stay away from yen positions.

China's central bank, the Peoples Bank of China (PBOC), has had to provide more and more stimulus to its economy, so movements vis-à-vis the dollar have caused weakness in the renminbi. No action is being taken by us around this situation, though.

Other central banks have reignited their fights against inflation, with surprise interest rate hikes lately, but the duration of these hikes and ability to keep rates at current levels are highly uncertain, meaning currency positions in these countries are not warranted.

Bottom line: The US dollar is headed lower, but uncertainty about economic weakness and the uncertainty around policy makers' dedication to current policies make us shy away from any currency positions right now.

Commodities

Commodities make the most sense as investments when they are in a bull market. A bull market occurs when there has been a lack of investment for a number of years while the world uses up those supplies discovered in past exploration phases. The last commodity cycle peaked in 2011, and the commodity complex overall is showing supply concerns after a dearth of investment over the past few years.

In addition, the world's central banks' easy money policies of the past couple of decades, supercharged by the Covid-lockdown fiscal and monetary stimuli around the world (but headlined by the US) have led to inflation. Inflation and high amounts of government debt from excessive spending both favor investments that hold their value as devaluation and future waves of central bank stimulus (to buy government debt) will lower the value of currencies around the world. This is already happening, as we see the US dollar hitting 14-month lows in July as the market anticipates an easier Fed and continued massive US government spending (and the large increases in debt that must support it).

Central banks around the world see these same phenomena, and they are reacting in the same way: central bank buying in 2022 was the highest since records started being kept in 1950 (1,136 tonnes) and 2023 year-to-date buying is above average for recent years (230 tonnes through March 2023) [data is from the World Gold Council]. Central banks are diversifying their own currency-laden balance sheets and adding more gold for stability and more diversification.

One last point: gold bullion and gold stocks tend to outperform in recessionary times. The investment bank Schroders produced a study on January 24, 2023 called "What could a US recession mean for gold and gold equities?" In it, they examine every recession since the 1970s and compare how gold bullion and gold mining stocks did versus the S&P 500. As you can in the table from the article below, on average, gold bullion advanced 28% during the recessionary period and beat the S&P 500 by 37%. Gold stocks were 61% higher, and they outperformed the S&P 500 by 69%. This includes the 1980 &

1981 performances where gold had screamed up from $35-40/oz in 1972 to $800/oz in 1980, so the losses were from very high levels, a condition we don't have today, especially when comparing the amount of gold used for investment versus the amount of money supply created by central banks over the past few decades. This table shows the attractiveness and counter cyclicality of gold investments during recessionary times, which we appear to be entering.

Summary of gold and gold equity absolute and relative returns through historic US recessions

Schroders

Recession year	Recession length (months)	Gold bullion performance (absolute) %	Gold bullion vs. S&P performance (relative) %	Gold stocks[1] performance (absolute) %	Gold stocks[1] vs. S&P performance (relative) %
1973	16	39	79	85	131
1980	6	71	37	184	125
1981	16	-14	-31	8	-10
1990	8	-14	-27	-22	-35
2001	8	19	60	103	174
2008	18	69	128	39	88
2020	2	24	11	28	14
Average	**11**	**28%**	**37%**	**61%**	**69%**

Sources and notes: [1]Gold stocks performance represented by Barron's Gold Mining Index (BGMI) for 1973, 1980, 1981 and 1990 recessions and the FTSE Gold Mines Index for 2001, 2008 and 2020 recessions. Recessions defined using NBER U.S. Recession Indicator. 607163.

Base metals have also seen below-average investment over the last few years due to investors' perceived better returns in higher growth equities and fixed income, and efficiencies and extensions of working mines that prolonged their lives, leading to less capital spending but leaving a far less certain future. Green energy initiatives are planned on having much larger supplies of copper, nickel, steel and many other metals than are currently available. The industry needs to expand but the capital has not been supplied to these industries yet, and industry prospects have not yet attracted the investor base needed to drive stock prices higher and allow more capital to go to industry to start more expansions/new location development. We think investments in current producers will prove lucrative as current operations will prove to be much more valuable in the future; these companies are also the logical agents of expansion and future development.

The Russian invasion of Ukraine has caused the world to re-examine the supply/demand relationships of a number of commodities, highlighted by food and energy. Currently, the developed world has sanctioned most energy and metal commodities, but food is able to be sold widely (although the agreement that governs this situation is up for renewal and negotiations are not going well). Also, most sanctioned commodities are being sold to developing world countries or China, India and other non-aligned large countries that use what they need but re-sell large excesses to the rest of the world, much of which finds itself into developed world economies. The ineffectiveness of the sanctions is most evident in prices of many commodities dropping to pre-war (but still elevated) prices. However, as the war moves closer and closer to a multi-year stalemate, political forces may push for more economic actions, which could include more airtight sanctions, which would lead to tighter commodity supplies and higher prices.

Finally, and again covered above in the Equity section, the advent of a rather strong El Nino in the past couple of months is leading to droughts in some formerly fertile regions, which could re-energize agricultural commodity prices due to problems in supplies, especially if any hiccups occur in world food distribution due to the Russian invasion of Ukraine.

Bottom line: We continue to own precious metals, especially precious metal mining companies with high grade deposits, geographically safe mine locations and reasonable costs of production. We continue to invest in base metal mining conglomerates and copper producers to take advantage of attractive supply/demand situations and the continued push toward expanded green energy infrastructure build-out. We like the agricultural commodity set up and are invested in ag supply companies like fertilizer producers as well as trading companies. We believe inflation will continue as long as governments continue their large amounts of spending, and central banks provide more stimulus whenever there is a crackup in financial markets.

Energy

In spite of the mild winter in the northern hemisphere which removed the extreme worry over energy supplies in light of Russia's invasion of Ukraine and the upset and sanctions that reshaped the energy transportation world of 2022-23, the world energy situation still remains a concern for governments and investors alike.

Oil prices fell throughout much of the second quarter as China's economic recovery was judged to be subpar and producers, most conspicuously Russia, produced above their OPEC+ quotas. However, many of these perceptions have proven to differ from reality, leading to an improvement in prices as demand has proven to be more resilient than early reports. The International Energy Agency (IEA), thinktank for the developed OECD countries, still projects oil demand to grow this year 2.3%, which includes US growth of just 0.5%, but Chinese and Indian growth of 5%, and other Asian, Middle Eastern and African growth all higher. April 2023 petroleum usage in China ended up being an all-time record, putting to bed some demand concerns; Chinese power usage is up 5.2% over 2022 through the first five months, and May Chinese power usage was 7.4% higher than May 2022 – petroleum usage is expected to mirror these power use levels.

Supply is where the concerns were, but overproduction by Russia and UAE as well as perceived high levels of inventories have weighed on prices through June. Russia is finally reducing production by 500,000 bbls/day in July, tightening supply, which is being reflected in the markets. In addition, other sources continue to struggle to keep up with their current production levels: Mexico's recent fire at Cantarell knocking down production by at least 100,000 bbls/day is a good example. In addition, refining additions around the world have been offset by outages at many plants, the big fire at Iran's Bandar Abbas refinery is a particular example, where running refineries flat-out without periodic maintenance hurts overall operational capacity over time.

US inventories are relatively low, but this has not phased the market much yet. Crude oil inventories are in the middle of the 5-year range, but of course, this increased inventory level is inclusive of a large amount of the Strategic Petroleum Reserve inventory, which continues to be sold weekly, lowering the overall SPR levels back to those of the early 1980s. Gasoline and diesel/heating oil inventory levels are barely above the 5-year lows, and there have been reductions in inventories over the last couple of weeks as US consumers travel at historic levels.

European energy, while dodging the proverbial bullet in the just concluded mild winter of 2022-23, has already started to react to possible shortages for the winter of 2023-24 as natural gas prices continue to be higher than late spring levels.

US natural gas prices have stayed low throughout 2023 as leftover winter inventories and ample production have combined to provide enough for air conditioning load in the southern US at mid-$2.00/MMBtu through July.

<u>Bottom line:</u> We continue to favor oil and gas investments, including supermajors, independent producers, refiners and pipeline companies due to the attractive supply/demand fundamentals worldwide, their relatively lower lifting costs and superior return of capital to shareholders. We also own some coal companies as China as well as other European and Asian countries continue to grow their worldwide coal consumption. We believe lower drilling activity, continued high demand and lack of any significant new discoveries will allow these investments to pay very attractive current yields while leading to additional capital appreciation over time as prices continue to rise.

Summary

The US economy (and other developed economies) will continue to slow, due to pockets of strength in certain sectors and continued extensive government spending over the next twelve months (pre-election). This slow growth accompanied by inflationary pressure will continue to improve fundamentals for energy, commodity and other companies that have had recent pricing power and are conscious of cost management. Rising interest rate and shrinking liquidity (continued QT and bank shrinkage) should continue to put pressure on bonds, and if history is any guide (like in 2022), also on technology/communications and consumer discretionary stocks, again causing a rotation from high valuation growth stocks to more cyclical value stocks.

Kanos Quarterly Commentary

Valuation Matters … When Most Least Expect It

<u>History:</u>
The 1960s and 1970s economic and financial travails influenced policy makers for decades afterwards. The high valuations and building inflation of the 1960s led to even higher inflation and a stock and bond market bust in the 1970s that left the US economy much more vulnerable than any time since the 1930s Great Depression. Policy makers of the 1980s were hell-bent on building for growth, but, since inflation had been slain by Paul Volcker's Fed in the late 1970s/early 1980s, they wanted to make sure that economic expansion had a monetary backing to finance expansion.

Thus, when the Crash of 1987 happened, Alan Greenspan's Fed flooded the financial system with liquidity to make sure that US financial markets would continue functioning, which ended up defining monetary policy for the next few decades. When US markets went into turmoil in 1998, 2000, 2003,

2008, 2009, 2010, 2013, 2018 and 2020, Greenspan and his successors, Ben Bernanke, Janet Yellen and Jerome Powell, either cut interest rates to historic lows and/or injected money directly into the financial system through "quantitative easing," direct buying of Treasury and mortgage bonds, to ease monetary conditions and "grease the path" to economic recovery and (hopefully) new economic growth.

The economy from 2009-2015 grew very slowly, and the Fed keep short-term interest rates near zero, while continuing to implement new rounds of quantitative easing. Only after six years of extremely easy monetary policy with near zero interest rates did the economy finally start to grow at more historical levels, but the easy money conditions allowed financial markets to absorb massive amounts of liquidity earmarked for the economy but unwanted. Long-duration assets like technology stocks did very well during this period, in spite of slack demand in many of the economy's sectors. The rise of social media and ad-supported tech companies ballooned this important but heretofore cyclical sector into a dominant position in the stock markets of the world and a large say in how technology was used, especially as mobile apps became widely used.

As the economy recovered further during the mid- to late-2010s, the Fed kept interest rates a very low levels (only raising to 2.25%), stimulating an already recovering economy and eventually leading to many new speculations: cryptocurrencies, special purpose acquisition companies ("spacs") and increased activity in leveraged buyouts of businesses using cheap financing to buy cash-flowing businesses by those with ready access to bank financing made cheap by Fed easy-money policies ("private equity").

The latest episode was the monster 2020 economic stimulus as Covid-19 hit the United States: 0% interest rates for the financial system accompanied by heightened fiscal stimulus programs to a covid-closed economy: money given to consumers and interest-free, forgivable loans to businesses. This huge slug of liquidity led to immediate spending that, accompanied by supply-chain problems, led to shortages of goods (and services) and thus higher prices, with shortages lasting for up to 24 months, elongating waits for goods and services but also channeling people's liquidity into "investments" of all types, from those needed most by economies to those judged "easiest to get rich," including meme-stocks, cryptos, SPACs, digital "art" and many other vehicles.

Recognizing belatedly the effects of inflation, the Fed changed their accommodative rhetoric in early 2022, raising interest rates starting in March of 2022 to 5% by May 2023, to fight inflation head-on, and realizing they might have to "break something" during the process [their words]. The most visible "breakage" came in March 2023 when some large regional banks, namely Silicon Valley Bank, Signature Bank and Silvergate Bank, became the 2nd, 3rd and 4th largest bank failures in US history. To compensate, the Fed opened a new debt-swap facility, de-stigmatized usage of the Fed's discount window for bank borrowing and bailed out <u>all</u> <u>domestic</u> depositors in those banks, including all deposits above the FDIC-insured levels (much of this money had been invested raised for speculative venture capital investments, so it was money lent out and lost by the bank that went back to speculative-minded investors). In all, the March 2023 easing and depositor-rescues resulted in hundreds of billions of available liquidity in the US financial system, much of which ended up in the financial markets.

The recent new releases in AI technology have created a frenzy in the investing public (especially institutional investors, who have seemingly caught the "fever" much more so than retail investors). A very poor 2022 financial market performance has led to an obvious rebound in the stock market in 2023, but how far can that extend?

KANOS
CAPITAL MANAGEMENT, LLC

Kanos Thesis:
With the new 2023 liquidity and the Fed pausing recent interest rate hikes, the stock market seems to think that the US economy can achieve a soft landing, avoiding the scourges of a bad recession. Meanwhile, employment is still buoyant while the Fed is still talking about raising interest rates and is still removing liquidity from the economy through quantitative tightening while the US Government, fresh off the debt ceiling agreement, has been borrowing lots more money to replenish government accounts, tightening financial conditions. The combination of tightening financial conditions and indicating higher rates has our attention, while the stock market is still focused on the Fed's pause and the anticipated lowering of interest rates once the soft landing has occurred (currently thought to be January 2024, according to current market pricing).

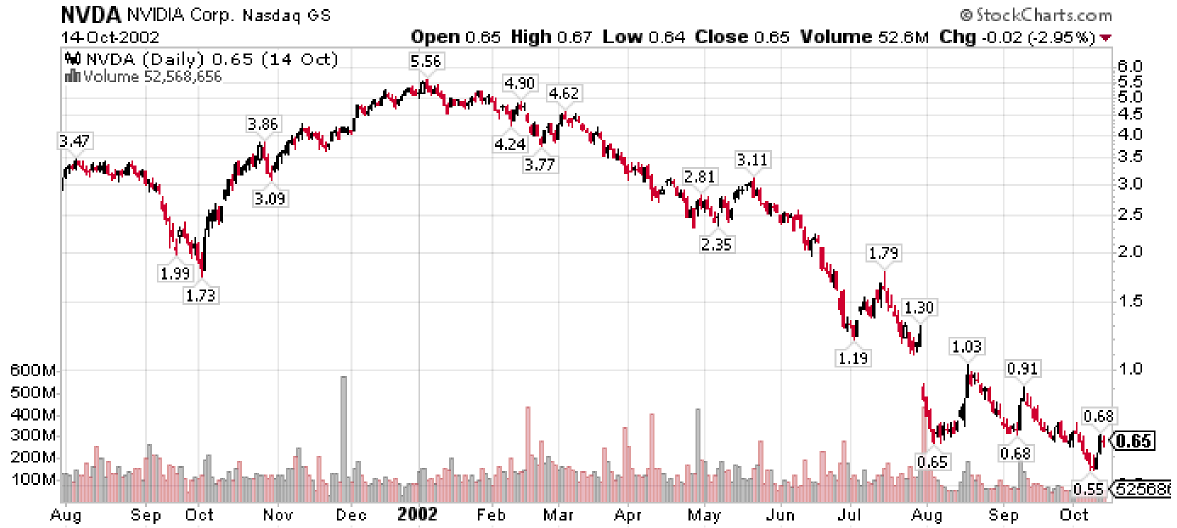
Does the stock market's position make sense, especially judging on historic norms? In our experience and studies, the bottoming of economic cycles (recessions, typically) and markets occurs when participants/investors have reached a point where values are compelling and opportunities are widespread. Currently, financial assets not only don't seem to be at "bottoms," but in many cases, valuations are much closer to historical highs.

It makes sense to us to look at numbers to help crystalize our theses, so let's look at some examples:

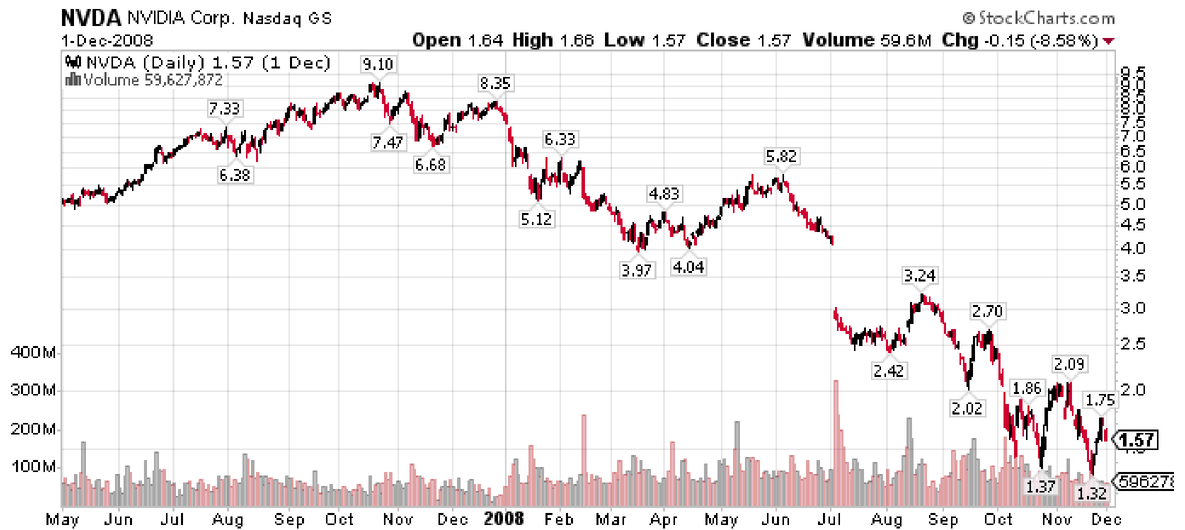
1) Let's start with today's market darling, Nvidia; it is the world's first trillion-dollar market cap semiconductor company that sells at extremely high valuation multiples: 238x trailing P/E multiple and a 44x forward P/E. Its P/Sales is an extraordinary 43x, its P/Free Cash Flow is 239x and it has a microscopic 0.03% dividend yield.

   A multi-decade investment veteran quoted frequently in noted value manager Bill Fleckenstein's blog, Ask Fleck, known as Mr. Skin, has invested since the 1970s, and has this recent commentary (5/31/23) on Nvidia's situation/valuation: "I know that any and all things "AI" will grow to the sky, (uninterrupted, of course). If we take the company's SALES projection for the next quarter, say, $11 billion, and annualize that number (ridiculous, but just stay with me here) to say, $44 billion, THEN double that for the following year (OK, so far?). Now we get projected SALES two years out of $88 billion. That's just great but maybe that's a bit "pie-in-the-sky-ish" so let's trim the third year to only 50% growth, arriving at $132 billion in SALES. At today's 400+ tick, the company is "valued" at "only 7.7X fantasy sales three years out. Of course, we have to ignore the fact that today's stock price "values" the company at about 23X insanely projected SALES over the next year. The most exaggerated "tech" bubble EVER took place in 1928-29 when RCA captured the imagination of every speculator with a pulse. At times the stock's trading volume accounted for up to 20% of total NYSE volume. At the stock price peak, in September 1929, the company was "valued" at $665 Million (5.8 million shs x $114.75). Meanwhile, sales had climbed from $65 million in 1927, to $102 million in 1928, to $182 million in 1929. Thus, at the peak of the RCA frenzy, the company was "valued" at "only" 3.65 x SALES. By 1974, annual sales grew to $4.6 billion, yet the stock price bottomed that year at 38, about 1/3 its 1929 high. Conclusion, NVDA is just a "bit" overvalued, but could get even more so in a fantasy world…"

   In addition, NVDA has been extremely volatile in the past when its earnings collapsed after cancelled orders when demand evaporated. It hit its Y2K tech boom high at the end of 2001 at $5.56 per share. In ten months, it fell to $0.55/share, or 90.1% as orders from its many soon-to-be-bankrupt customers disappeared and the business virtually collapsed – see chart below.



In late 2007, as the banking crisis started to get worse, Nvidia hit its high of $9.10/share in October. A year later, the stock hit a bottom at $1.32, losing 85.5% of its value as technology companies cancelled orders with a recession in full swing.



In early December of 2021, near the end of the Covid recovery bubble, NVDA stock hit a high of $346/share. As investors became fearful of an oncoming recession and a series of Fed rate hikes as inflation ballooned, the stock hit a low of $108.07 ten months later in October 2022, a loss of 68.8% of its value, and the recession hasn't even occurred yet (see chart below).

Nvidia is a volatile technology stock that exhibits the euphoria of a tech boom at its highs as the agony of a tech bust on its lows. At these valuations, does Nvidia seem closer to a top than a bottom? We think so.

2) Apple, the world's most valuable company at almost a $3 trillion market capitalization, reported in their most recent quarter a 2.5% fall in y-o-y quarterly revenue and a 3.4% fall in y-o-y quarterly earnings. However, sporting a 24.5% profit margin, the stock sells at a 31x trailing P/E ratio and a 28x forward P/E. Price-to-sales ratio is a high 7.6x and Enterprise Value/EBITDA (a good approximation of price-to-cash flow) is 23x. For comparison's sake, at Apple's October 2012 high after the 2008-2009 financial crisis, its trailing P/E was 16x, forward P/E was 13x, price-to-sales was 4x and EV/EBITDA was 10x, at a time when Apple's addressable market was still huge; today, saturation and high selling prices means Apple's ability to expand seems much more difficult than in 2012.

   Fred Hickey writes the High-Tech Strategist newsletter, and this was his comments on Apple from the June newsletter "Déjà vu 2000": "Apple's Q1 numbers were inflated by backlog and channel filling of high-end (high margin) iPhone Pro and Pro Max smartphones that were in shortage during the Q4 holiday selling season…This fits with the Cleveland Research report (mentioned in [prior] letter) that noted Apple's iPhone sales had been relatively strong in January and February but then tailed off significantly in March, with April sales even worse. The backlog from supply shortages had ended. [In late May, research firm] Loop Capital downgraded Apple to "hold" from "buy" on "material downside risk" to Apple's June quarter…[noting] Apple has cut orders and shipment forecasts to its suppliers for iPhone builds by about 5 million units…the second cut in the last four weeks. I haven't seen much written about the iPhone 15 to be introduced in September – probably for good reason. From a features standpoint, it apparently is a nothing-burger…"

   Apple is, for the majority of its revenue, a hardware company, which typically carry lower valuations because they contain less valuable intellectual property (IP) and carry a higher price tag, meaning they are harder to mass sell. For example, Dell, another hardware company, has a trailing P/E of 21x and P/CF of 5.3x while Microsoft, which provides Dell's main software (operating system [Windows] and business app [Office], sells for a trailing P/E of 37x and P/CF of 24.4x. With Apple's trailing P/E of 31x and P/CF of 53.6x, Apple seems significantly

overvalued as it has a much lower operating margin than Microsoft and more dubious future growth and profitability prospects.

Finally, just like Nvidia, Apple has been through a number of significant recent price drops, which does not bode well with its high valuation and questionable growth prospects. These price declines include a -83.1% decline in 2000-2002, -61.5% in 2008-2009, -44.8% in 2012-2013, -39.0% in 2018, -35.0% in 2020 and -31.6% in 2021-2022.

3) No equity valuation comparison these days could be called complete without a look at Tesla. After troughing at the end of 2022 at $102/share, the stock trades near $280, at just under a $900 billion valuation. With a trailing P/E of 82x and forward P/E of 59x, a P/Sales of over 10x and P/CF of 39x, this seems like your garden-variety big cap tech growth stock. Especially when compared to Ford's valuation parameters (Ford is advanced in EV production and marketing for a legacy car company): trailing P/E of 21x, forward P/E of 9x, P/Sales of 0.37x [not a typo] and P/CF of 1.5x. But how is Tesla's prospects for this year and next, which is what analysts use for their earnings estimates and valuations? Growth in Q1 was sub-par, with lower margins and Tesla cutting prices multiple times in the past few months to compete with other EV competitors, most notably in China, its biggest market. Its projected next 5Y earnings per share growth is 10.85%, impressive but nowhere near what it needs to be to justify this sky-high valuation. Inflation has already raised raw material prices for Tesla's products but even sourcing in the future will be harder, reducing its competitive margins in an increasingly competitive market for electric vehicles. Investors point to Tesla's "future potential" and all of the new products that could come from its current technology (self-driving cars, self-driving taxi fleets, electric eighteen-wheelers, etc.), but these products have long been in development and have proven to be much more difficult to produce, much less monetize; thus, the company seems undeserving to get a far higher valuation for what was called in the 1980s-1990s "vapor wear" (software that was promised and in development but never ready for release to users).

   Finally, just like Nvidia and Apple, Tesla has been through a large number of significant price declines, including most recently a -63.8% decline in 2020 and -75.4% drop in the 2021-2022 bear market.

4) Finally, we will look at a more prosaic company, one that almost all institutional investors own, and a decades-long favorite of Warren Buffett: the Coca-Cola Company. KO has one of the most recognized brands in the world, has overcome marketing missteps and has successfully partially pivoted to waters and other drinks as soft drinks have lost some of their appeal. However, the numbers for this large, relatively unchanged company are challenging looking forward: trailing P/E is 27x while forward P/E is 22x; P/Sales is 6x and P/CF is 18x, with a P/Free Cash Flow of 81x, meaning much of the cash flow is not available for expansion or return to shareholders. Debt-to-equity is a high 1.7x, which KO management believes works because of the company's consistent cash flow to satisfy debt service. However, results have been slow: 5Y sales gains have only averaged 3.5% while 5Y EPS growth is a higher 14.3% (helped by high leverage, no doubt). Projected Next 5Y EPS growth however is expected to slow to only 6%, meaning KO's 77% payout ratio to shareholders, who currently enjoy a 3.1% dividend yield, may see the dividend threatened, especially if consumers are crimped by recessionary forces worldwide.

Finally, just like the tech stocks discussed above, Coke has been through a number of significant price drops in the past few years, which is a concern with its high valuation and low growth prospects. Price declines include a -84.2% decline in the 1998-2003 period, -41.2% in 2008-2009 financial crisis, -40.6% in 2020 and -18.5% in 2022.

Investors have gotten so used to low interest rates, use of leverage and central bank stimuli that current valuations are back above the Tech Boom / Dot.com bubble valuations of 2000, although not back to the absolute high valuations of the recent "Everything Bubble" that topped in late 2021.

The following graph from Advisor Perspectives 7/5/23 shows a great visual depiction of the current overvaluation: the stock market is currently more than 62% higher in valuation than the entire US economy's Gross Domestic Product (for reference, the top of the 2000 dot.com bubble was only 59% higher). Between the early 1950s and the mid-1990s, the stock market varied between one-third the size of the economy and seven-eighths of the US economy. The easy money-caused bubbles of the late 1990s-early 2000s and forward caused valuations to go up when arguably, the US economy has slowed down over this time frame from more structural growth in the 1980s-1990s. This Equities-to-GDP is labeled as Warren Buffett's favorite valuation ratio – he believes it is the best indicator (if you could only use one) to indicate under- or over-valuation of the stock market. It looks overvalued to us.

We are most concerned because few professionals working in the financial markets have seen, lived through and survived financial markets with a real inflationary spiral that may reignite in the next few months/years. The vast majority of finance professionals were not around in 1987 when the stock market crashed. Still only a few were working through the 2000 tech dot.com bubble and subsequent 2+ year bear market in technology shares in which many went down so far that they have taken more than 20 years to get back to pre-2001 levels.

In fact, the majority of people participating in financial markets have not really been involved when central banks, the Fed most notably, didn't provide support/stimulus when one of the US financial markets had a big problem. When the market peaked in 1973, plunging more than 50% to the low in 1974, the Fed was not in a position to provide big liquidity injections, nor was it in the early 1980s when we had large bank failures that the system just had to work through, most notably Continental Illinois in 1984. The Fed was still traumatized by the 1970s-early 1980s rampant inflation, and they knew they couldn't introduce liquidity/lending to big banks without reigniting inflation.

The markets, and so the majority of firms and players in the US financial world are convinced that: 1) the Fed will stop raising rates imminently, 2) the Fed will start to cut rates after that, possibly within just 3-6 months, 3) long-dated assets like big tech companies will go up again because their earnings and prospects will rise with lower interest rates and a recovering world economy, and 4) Private equity/venture capital investments will start to work again. The valuations we have been highlighting above is the first step of this – put money to work in proven winners, regardless of the valuation, and then move that money to smaller, even higher growth opportunities as the "new boom" takes off.

However, as market veterans who have experienced the Crash of 1987 and have invested money since that time, we think the abovementioned sequence of events will have a hard time occurring in 2023-2024 mostly because we still see indicators that the economy is slowing down and that recessionary forces are not ebbing but building. Meanwhile, while we have reached much lower levels of inflation that registered just a few months ago, inflationary consumer behavior (spending on large trips, buying cars, houses before prices rise more) have not been totally vanquished, and inflation could reignite, possibly soon, as geopolitics, underinvestment in raw materials and continued large amounts of government spending before 2024 elections combine to underpin some inflationary forces. If the economy continues to slow and inflation stops dropping or starts to rise again, the Fed might act to lower rates, but it has tried to fight inflation first and foremost, with the financial markets a distant second concern, although the financial system, i.e. commercial banks, are still a concern for the Fed, thus pointing to possible future action if banks need more support with rates staying high.

The conditions that would cause big tech prospects to rise appreciably and for private equity / venture capital to work, i.e. falling rates and plentiful liquidity, would only occur post a recession, when rates would go down to stimulate demand which has evaporated and liquidity is low and needs to be raised (not the current concern – the Fed is still withdrawing liquidity with QT, not wanting to add any to the economy). Thus, only emergency conditions would cause lower rate and higher liquidity, and crisis/ emergency conditions would point toward poorer prospects for big tech, private equity and venture capital, which could result in another waterfall decline as recapped above in the Nvidia, Apple, Tesla and Coca-Cola analyses.

The Managers of Kanos Capital Management
© 2023 by Kanos Capital Management, LLC All rights reserved.