KANOS
CAPITAL MANAGEMENT, LLC

Third Quarter 2023 Investor Letter

Third Quarter Market Review

After a strong second quarter, US financial markets backed off during the third quarter, spooked by higher interest rates driven by high and rising supply of government bonds, better-than-expected economic results and the growing realization that rates are going to stay "higher for longer," in Fed parlance.

US Treasury markets were the epicenter of this activity, with longer-dated Treasury notes, as represented by the iShares 20+ year Treasury ETF (ticker: TLT), falling -13.8% during the quarter – a very large loss for the bond market and unexpected, as the TLT gathered a huge amount of assets under management as investors poured more money in to try to take advantage of a future drop in rates, which has currently failed to materialize. Short-term rates still yield more than notes/bonds, so the move to long-rate holdings has been an attempt to capture capital gains.

Meanwhile, the newer technologies that have driven equity gains faded this quarter as an economic driver. Artificial intelligence (AI) and electric cars had driven much of the equity gains this year, but the stocks at the forefront of those moves, Nvidia for AI and Tesla and the Chinese EV makers are far off their highs and no longer drive equity moves higher. This drove equity markets down, with only Energy and Communications higher for the quarter.

The majority of Kanos portfolios held up well during the third quarter, staying relatively flat versus a -3.3% loss for the S&P 500. Our portfolios were hurt by our precious metals positions which dragged down quarterly results; luckily those have bounced back strongly in October. The standout performers in Kanos portfolios were energy stocks, led by ConocoPhillips +16.8%, ExxonMobil +10.5% and Chevron +8.2%. Many of our larger holdings retreated after strong performances earlier in the year: Merck was down -10.2%, Microsoft -7.2% and Proctor & Gamble -3.3%. Our larger gold mining stocks outperformed the gold miners index, but Agnico Eagle mines still fell -8.5% while Alamos Gold was down -5.2%.

In market statistics, the S&P 500 was down -3.3% to 4,288.05 while the Dow Jones Industrial Average performed slightly better, only losing -2.1% during the quarter (all performance numbers reflect total returns). Sector performances were almost all down, with the only upside leaders being Energy (+12.3%) and Communications Services (+1.1%). All other sectors were losers during the quarter, led lower by interest sensitive sectors Utilities (-9.3%) and Real Estate (-8.9%) but also included Consumer Staples (-6.6%), Industrials (-5.2%) and even Technology (-5.6%) (again, all performances reflect total returns). Fixed income markets resumed their march lower, influenced by decent economic statistics (i.e., no Fed rate cuts in the near future) and larger supply (Treasury selling more bonds to cover higher spending and higher interest costs); both governments and corporate short-term bonds showed quarterly returns of between flat and -0.5%. The 10-yr US Treasury bond ended at 4.572%. The US dollar rose during the quarter, up a rather hefty 2.75%, which puts pressure on foreign stock markets, most of which were lower during the quarter: some European indices were

up less than 1% during the quarter, while losers were led by Hong Kong's Hang Seng down -5.9%, Japan's Nikkei -4.0% and Europe's Stoxx 50 was down -4.4%. As mentioned above, energy was the star, with Nymex crude oil up 28.5% and diesel up 37.3%. The stronger dollar hurt some commodities (gold was down -3.8%, agriculturals were down between 14-16%), but favorable supply/demand conditions drove up: orange juice (+28.7%), sugar (+14.8%), cotton (+4.9%), cocoa (+3.0%) and cattle (+2.0%), showing that many commodities continue to outperform in spite of dollar headwinds.

Looking Forward

Introduction

Continued weakness in US Treasury bonds is weighing on investors' psyches more and more The potential 'savior' of years past, the Federal Reserve, continues to see inflation above their targets, continued gains in employment markets and decent economic results and are calling for continued higher interest rates, most probably for a longer period than typically happens after the cessation of interest rate increases.

Investors seem to continue to have a hard time with the concept that "things have changed" – a theme we've continued to emphasize but the markets have had a hard time processing. For more than thirty years, rapid globalization allowed firms to move operations (and costs) to lower cost countries, allowing the developed world to import the deflation of lower wages and operating costs. This systematic disinflation of costs allowed the Fed and other central banks to lower interest rates during times of economic downturns without fear of a flareup of inflation in commodity and retail pricing. Lower interest rates did allow asset inflation to occur, as lower interest rates caused lower carrying costs and thus higher values, all else being equal. That the Fed and other central banks raised interest rates grudgingly and only as little as they could muster was lost on market participants – asset values have grown far more than economic growth would have predicted.

The emergence of nationalism in many places, headlined by China but also in the US and Western Europe, initially promoted globalization as more and more of the world wanted to participate in the prosperity spurred by the lowest interest rates in history However, we believe the lowest costs have been achieved as the personnel, materials, fuel and other costs used to produce the tools, parts and machines of our technologically advanced age are harder to find and must be located strategically (reshoring/"friend"-shoring). The supply of cheap commodities, discovered in the twentieth and earlier in the twenty-first century, have been depleted, requiring new discovery, development and production of not-as-cheaply found and produced supplies. Finally, changing geopolitical relationships, some would say driven by generational changing-of-the-guard and also deteriorating demographics worldwide, has spurred conflict, war and possibly revolution in a growing number of geopolitical hotspots, putting the final nail in globalization, causing higher costs for transportation, security and sourcing of materials and machinery, institutionalizing higher costs and thus, reduced economic growth potential and possibly growing inflation.

Equity investors, especially those involved in US equity markets, don't appear to understand this at least semi-permanent change in the world and in financial markets, instead trying to run the playbook of yore where gathering economic deceleration and possibly negative growth would send the Fed lowering interest rates to head off this economic weakness. Of course, lower interest rates would then buoy financial assets (usually through a growth or even surge of money growth), allowing for growth in

financial markets, both in higher levels and higher quantity of capital offerings to foster the growth brought on by easier financial conditions. We believe that these days are gone. Lowering interest rates will now reignite higher inflation which will propagate through world financial systems, causing expanded economic hardship, especially most of the world's population who struggle financially because of limited ability to afford higher priced food, fuel and essentials with wages that have not been keeping up with inflation, even in the recent past.

Finally, the US government's "damn the torpedoes, full speed ahead" spending increases of recent years and continuing into the future with no end in sight drives the inflationary impulse even further, as the government is financing new infrastructure for their extensive green initiatives as well as for the replacement of aging infrastructure through the various spending bills passed over the last few years. Couple this with this Administration's active war against traditional fuels, mainly coal, oil and gas, and the thought that inflation will return to 2% and stay there seems ludicrous to us, and we will continue to invest your capital in ways that will take advantage of these conditions and the biases against what we see as fantastic investment opportunities going forward.

We want to reiterate our mission: at Kanos our job is to grow our clients' portfolios over time, to preserve value during bad times, and earn income on investments 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 perform to that potential in a reasonable investment timeframe. We have tried to avoid overvalued situations and invest in attractive probable returns with judged lower risk profiles over time. Finally, as macro-strategist and financial writer Jared Dillian puts succinctly: "[We] want to be positively exposed to things that gain from disorder." There is more disorder in the investment world than in most years in the recent past, so having things that react positively to the growing disorder is paramount.

Economy

The US economy is the real conundrum in the current "investment equation." The Fed has repeatedly noted that employment is still robust and that consumers continue to propel a moderately-growing economy, which are underlined by the just released third quarter GDP growth of 4.9%, more than double the 2.1% rate achieved in Q2 and above consensus expectations of 4.5%. A sharp increase in personal consumption drove the gains, helped by a 4.6% increase in government spending and even housing investment. In fact, September housing sales beat consensus also, showing housing has held up pretty well in the face of much higher mortgage rates.

Meanwhile, there are plenty of indicators that point toward falling growth or even contraction: eighteen straight months of falling Leading Economic Indicators, Purchasing Managers Surveys that are flat-lining around the zero-growth line, growth in temporary employment while job losses occur mostly in permanent positions, etc. But travel and leisure, dining out and meal and entertainment have continued to grow, moderating an immediate slowdown.

Inflation, while having calmed down from earlier high levels, has leveled off and increased slightly in the last couple of months, pointing to how ingrained price increases have become, especially in services. More strikes and job switching have caused labor prices to go up, and we seem right back in the 1970s with the big jumps in collectively-bargained wage gains for groups of employees, governmental, union and even non-union. And we have energy prices having bottomed and getting more expensive as winter approaches. So, inflation continues to be an issue, meaning that while rate hikes are probably on hold,

current relatively high interest rates are here to stay to try to drive down inflation over time. Finally, trying not to beat a dead horse, the Biden Administration's continued excessive spending has contributed directly to inflation nationwide, as the green new deal IRA projects compete with Infrastructure Act projects as well as private sector building to drive up construction materials, labor and machinery costs. And don't forget that war is typically inflationary as governments raise spending on arms and armies, with costs being a secondary concern. All these things point to inflation continuing to be an ongoing disruptive issue.

Continued high interest rates are also bad news for the banking system, which continues to have capital problems, cost issues and diminished lending capacity from so much capital being invested at low interest rates in the recent past. While there have not been more bank failures, it appears that the stress has increased as rates have continued to rise, but the BTFP program by the Fed has transferred that stress to the Fed, as it is financing underwater bonds from banks at par, ignoring the high and growing losses and allowing banks to work around those balance sheet losses (at least temporarily). But the Fed is sitting on an estimated $111 billion in losses – a problem that will have to be dealt with when the program is set to end during March 2024. High interest rates have put a lot of stress on consumers, many of whom have either floating rate debt or credit card debt which averages about 28+% nationwide! If customers start defaulting on loans, the banking system could lurch into another crisis, mostly affecting smaller and midsize banks.

So, the US economy seems to have so far avoided a recession in spite of high interest rates. Covid savings have been deployed by consumers, and the US government has stepped up with various forms of fiscal stimulus bills in the past couple of years that continue to help the economy grow.

Europe appears to be on the verge of recession, with manufacturing shrinking (according to PMI surveys below the 50 level) and services (with a PMI reading recently dropping below 50 also) confirming a slowdown and approaching recession. Luckily, they dodged the energy bullet last year with a mild winter (but with already high energy prices). Their economies will be further hurt if energy prices rise too much again due to a colder winter this winter, and that could spur deeper recessions across the continent, especially in Germany with its vulnerable formerly-Russian-centric energy situation.

Asian economies have been more resilient, although high interest rates and the resultant slackening of worldwide demand has slowed down East Asian economies slightly. China's export economy has been hurt by American reshoring and "friend-shoring" changes in global goods manufacturing and flow, although the Chinese economy itself has continued to grow, in spite of Western characterization of nearly recessionary conditions. How do we know? Both oil & gas usage as well as electricity usage have hit records in the past couple of months, meaning the Chinese economy certainly is at least growing slightly, if not more robustly. Japan and India have seen their economic growth slow, as reflected in their recently falling stock markets, but there is still growth in the region.

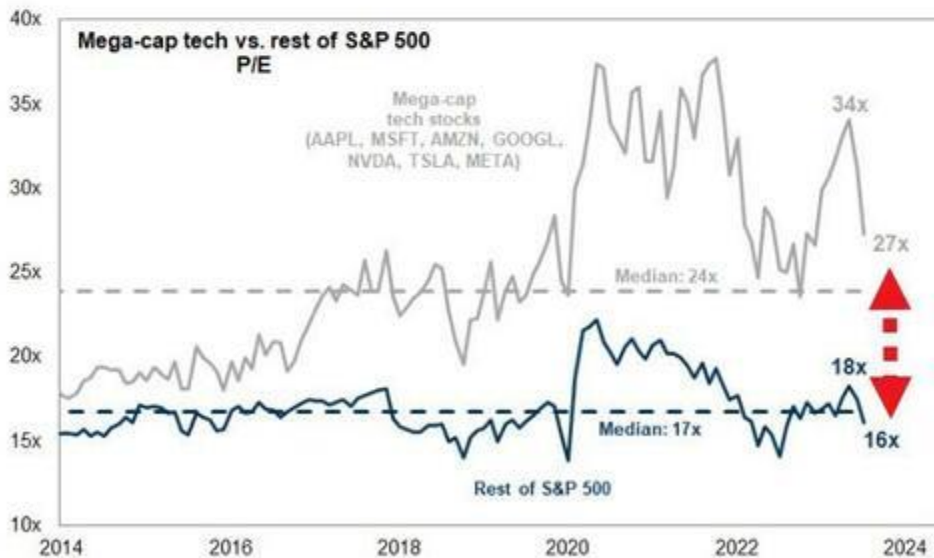
Bottom line: All the factors are in place for economic slowdowns in many parts of the world, but governments continue to spend their prior fiscal stimulus program monies and have helped keep economies growing across the board. However, we expect the "poison" of higher interest rates to continue to take its toll on businesses and consumers, continuing to slow economic activity, and as central bankers hope, inflation, also.

Equities

Equities had a miserable September and an uneven October. With long-term interest rates climbing daily during much of the period, investors were predictably pessimistic about gains in the markets, and some had a relatively large short position during the fall.

In spite of buoyant performance numbers by some of the big indices, only a handful of firms led by seven large technology companies have performed well this year. The broader markets, as represented by NYSE Composite and smaller firms as represented by the Russell 2000 index are largely flat and down 5%, respectively. The average stock in US markets is down slightly year-to-date, so the outperformance of the mega-cap stocks has masked a relatively lackluster year for US stocks.

The mega-cap technology stocks have mostly reported 3Q earnings in the past few days and, except for Microsoft's beating estimates and expectations of cloud growth, the results have matched expectations (many with slight beats of earnings estimates) but have suffered losses in stock price levels as investors have been unimpressed with results and forecasts at current valuation levels. The following comparison of mega-cap tech stocks versus the rest of the S&P 500 from a Goldman Sachs Investment Research report dated September 28, 2023 illustrates how much more expensive the "Magnificent 7" (Apple, Microsoft, Amazon, Alphabet, Nvidia, Tesla and Meta) are:



This valuation premium makes most of these companies harder to invest in, as we see future growth prospects pretty pedestrian for most of them despite potential technology advancements. Many other stocks, notably consumer staples (like Target, Pepsico Coca-Cola etc.), airlines/transports (Southwest, United, etc.) green energy/utilities (Enphase Energy, NextEra Energy, etc.) and lately consumer discretionary stocks (Tesla, Ford, Nike, etc.) have shown extreme weakness. We have avoided many of these stocks due to their elevated valuations and only so-so prospects, due to either their capital intensive nature or their exposure to weakening purchasing by consumers.

In addition, increased geopolitical upset most recently heightened by Hamas' attack on Israel and the resultant war between the two, along with the continued hostilities in Ukraine and tension surrounding Taiwan adds to the pessimism around the markets. Add in the continued high interest rates which continue to put a damper on corporate and household income as costs rise, and conditions seem poor. Finally, many mutual funds have their fiscal year end in October, and many sell their losers to avoid having to report them, contributing to autumn weakness. This often has resulted in an October bottom for the US stock market.

However, seasonal factors start to turn in the market's favor at some point during October/November, as earnings estimates are adjusted after 3Q earnings announcements, allowing for futures earnings surprises, while companies are able to buy back stock post-earnings for a lot of S&P 500 size firms that have large amounts of cash and fewer new expansion projects on which to spend. And finally, as of the November 1st meeting this year, the Fed is judged to have finished raising rates, with a slight chance of one last December hike. Typically, stock markets grow more optimistic when the hiking cycle has ended and rate cuts are the next thing to be anticipated and at some point discounted into prices.

All-in-all, we think all the abovementioned factors could lead to a kind of "last hurrah" fourth quarter rally. We don't think it is sustainable, and 2024 will almost certainly bring some form of recession. We aren't particularly optimistic about the two current shooting wars, in Ukraine and the Middle East, being resolved satisfactorily, but war is expensive and tiring, so we actually can see ceasefires having the possibility of happening, due to nothing else but war fatigue and running out of resources and money to continue the pace of fighting. Cessation of either war would lead to optimism in world stock markets, driving them higher, even if that bullishness is short-lived.

World stock markets are kind of all in the same shape – hoping for continued consumer growth, no matter how small. The Chinese economy inches along but still has growth – that is not great for Chinese equities but after a very rough year, they could be bottoming too. Japan and India have had good years in their stock markets, but both have paused their gains and may consolidate, staying in a range after recent gains.

As outlined in last quarter's letter, we continue to favor what finance writer and macro strategist Worth Wray calls "Essentials." We favor investments in energy, metals, soft commodities/ags/fertilizers as well as food companies, pharmaceutical companies, defense companies and infrastructure companies (steel, materials, engineering), and some select technology, consumer staples and other healthcare firms. These companies all provide essential needs in economies worldwide, and don't need booming economic expansion to thrive; our crumbling decades-old infrastructure and the wars using up of many materials and stockpiles mean that developed countries will be counting on constant supplies of commodities of all kinds, which will keep a bid in materials, processing and engineering companies of all types, even if economies slow down and sink into recession. Cheap, easy-to-extract commodities of many kinds have been used extensively, requiring harder-to-find, more expensive replacements that will keep many of our investments profitable and busy for years to come.

Bottom line: The stock market has had a lackluster year at best, unless you were overweight a few mega-cap tech stocks whose stock prices have held up even as their valuations are very high. However, as pessimism has reached a fever pitch, we believe the markets' seasonal factors and lack of further big selling pressure will lead to a fourth quarter rally. We will look to participate in the advance, but we

favor continuing most of our portfolios in 'Essentials' which we believe will benefit from constant demand and shrinking supply to be attractive for the next few years.

Foreign markets are in roughly the same boat, having had lackluster years but may have exhausted most selling pressure. Japan, India and other countries who've had good market years may pass the baton and just oscillate the rest of the year. Our Essentials positions give us a lot of international exposure, so we will not be looking to add new international positions per se.

Bonds

US bonds have continued their slide into October, as continued large supplies of Treasuries are auctioned weekly and other countries feel forced to sell Treasuries to defend their currencies as the dollar continues to strengthen, as China has done over the past few weeks.

US Treasury bond yields have risen to 5% for the 10-year, exceeding 16-year highs as investors are being asked to absorb larger and larger amounts of Treasury bonds. Short-term Treasuries have continued to be strong, but the longer end of the curve, from 5-years and out, have shown some weakness in October. There has been so much pessimism in bonds that sentiment says bonds may stop going down in value here, in spite of the Treasury's continued large auctions have forced so much "paper" into the markets.

In a recent report from Goldman Sachs, they outlined current and future issuance of Treasuries. Their forecast put overall Treasury issuance in 2023 at $727 billion. In addition, the Fed's quantitative tightening (QT) sales from their enormous portfolio and sales by foreigners (mainly central banks, especially China and Japan defending their currencies by selling dollar-denominated Treasuries), have allowed US households to buy <u>$1.7 trillion in Treasuries (mostly T-bills for yield)</u> in 2023! Even more staggering, the calendar schedules $1.17 trillion of Treasuries to be auctioned in 2024, 60% higher than 2023's issuance. You can see why we don't like bonds here – high and increasing supply of Treasuries for sale, traditional buyers are sellers, can the rest of the investing world absorb all this debt? For those with shorter-term needs for liquidity, we have invested in T-bills because they have no duration risk – it is the longer-term bonds that concern us most.

Corporates, especially high-yield bonds, have performed better than Treasuries as there has not been as much supply, but investment grade credits have issued only what is absolutely required due to the sticker shock of much higher rates, and lower quality corporates, including high yield, have had rates soar into double digits, making financing unattractive, but done if absolutely necessary.

International bond markets are also participating in post-Covid financings by governments around the world. China has just announced that they will finance 1 trillion renminbi (about $136 billion) of bonds to help improve infrastructure and property markets. The abovementioned Goldman Sachs report regarding government bond issuance shows the UK upping their Gilt issuance next year 26% to 201 billion pounds while the four big European countries (Germany, France, Italy and Spain) are expected to up issuance 21% to 311 billion euros. So there is supply coming from every corner of the globe, exacerbating the supply situation for bonds and driving up yields.

<u>Bottom line:</u> We still believe that the risks in bonds outweigh the rewards, especially with issuance skyrocketing in 2024 in what we see as an already-saturated world market. Inflation is still a problem

that has only had the easy part solved, so that is another headwind for bond investing in our minds. We prefer higher yielding equities with businesses that can pass through a lot of inflation and adjust to future economic conditions more flexibly than fixed income investments.

Currencies

The dollar has continued its rally against most other currencies as US bond yields have marched higher, making dollar denominated investments more attractive.

The ECB has been hawkish (although they paused interest rate hikes at their recent October meeting). They are trying to keep up with the Fed with interest rates to keep the euro and Eurozone competitive while still growing, but investors know the weakness of the hand of the ECB, that they may be called on to lower rates sooner and faster than the Fed, and thus the euro has continued to weaken against the dollar during October, making it unattractive.

The yen has also been weak as investors probe what Japan's Finance Ministry will do at the 150 yen/dollar level, which many consider the most defensible level. The yen/dollar has reached that level, and we shall see whether there are any fireworks sending the yen one way or the other.

China's central bank, the Peoples Bank of China (PBOC), has had to sell US Treasuries and US dollars to defend the yuan in recent weeks. They like a weaker currency for export purposes but must not lower the value too much and risk larger scale capital flight like has happened in the past and could happen if the yuan become too weak in relation to the dollar.

Bottom line: The US dollar is calling the shots in currency land. We think that a number of critical levels are currently in play, but the risk of investing in other currencies far outweighs the reward of taking sides in these currency situations, especially since we are naturally long US dollars.

Commodities

Commodities have been a much less popular asset class for investors due to a number of characteristics they typically exhibit: 1) they tend to trend in cycles, so they are good investments at times (during favorable uptrends) but less attractive when the trend reverses, 2) they tend to be more volatile due to the smaller size of each market (they are more analogous to small-cap stocks, also typically more volatile) and 3) they are more prone to large moves than many other investment classes because a lot of trading happens in futures markets where positions are typically levered, which means they can more often move in exaggerated moves when either long positions are liquidated (big 'down' moves) or short positions must buy back (causing big 'up' moves). Commodity-oriented stocks typically exhibit elevated 'beta' compared to the underlying commodities themselves, i.e. the stocks move more than the commodity moves, allowing for better returns on the upside but risking higher losses on the downside.

So commodities are less attractive due to their higher volatility, periods of being out-of-favor and their relatively small markets, meaning big investors aren't as interested in participating unless the trending moves are strong and look sustainable. We have been accused of being 'too early' in investing your capital in commodity-oriented investments, but that is really only evident in hindsight. The environment has been ripe for years, and large investors have ignored many of these attractive investments in order to

put more money to work in larger-scale investments like big tech that have not been nearly as attractive as our commodity holdings in many years.

We came upon a very good explanation of this in the most recent (October 1, 2023) issue of Fred Hickey's High-Tech Strategist titled *Precious Metals Capitulation*. He does a good job of explaining why a "high tech guy" now owns gold and gold stocks. Here is an excerpt that captures many of our same thoughts (and edited somewhat for length by us):

> "Every once in a while, I feel the need to explain how a newsletter titled "The High-Tech Strategist" became so deeply involved with precious metals a little over two decades ago. As I wrote in the August 2002 newsletter, my purchase back then of a "slug" of Newmont Mining stock was "a bet against Greenspan and the Fed, who I fear will flood the system with money as the stock market and economy continue to contract. It is a bet against the undisciplined fiscal spending and budget deficits." Here we are 21 years later and it's the same fear that keep me investing in the metals. Today our government has never been more undisciplined with its spending, running a $2 trillion annual deficit in a period without direct war involvement and with the economy not in recession. If the US economy was [to go into] recession, the deficit would be much higher.
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> "…[O]ur spendthrifts in government (both sides of the aisle) have gotten away with this monstrosity primarily because the Fed did continue to flood the system with money (as I feared) in ever greater amounts in "crises" (some of which the Fed itself helped create). In recent years, the Fed has been the primary funder (enabler) of the government money squanderers. Normally, when money is printed up (created electronically these days) it will lead to inflation, but thanks to favorable circumstances – such as low-cost/low-wage China becoming the world's manufacturing floor, consumer inflation was held mostly in check and the monetary inflation was only visible in the form of rampant asset inflation.
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> "…When the COVID pandemic emerged, our politicians saw the opportunity to placate [those who missed the asset inflation] with "free money" – courtesy of the Fed – which printed up nearly $5 trillion over just a couple of years – some of which was used to shower "stimmy" checks on the masses. This, of course, sent consumer inflation skyward (close to 10%). [Inflation has since moderated somewhat, but]…workers in the US and elsewhere are demanding higher compensation to offset inflation pressures (witness the proliferation of labor strikes and double-digit percentage wage hikes) and shortages of key materials (such as oil) will keep upward pressure on consumer prices. As past inflationary periods have show (think 1970s), once the inflation genie gets out of the bottle – its hard to get back in.
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> "Up until 1999, I never owned so much as a single gold coin and this newsletter was 100% tech-focused. Virtually all my investments had been tech-related for the prior two decades and I was lucky enough to be in the right place at the right time. I grew up and lived with the Route 128 tech corridor in Massachusetts – known as the "Other" Tech Valley (right place) and became an active investor from 1979-on. It was the right time, as tech was the best sector to be invested in during those stock

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> bull market decades of the 1980s and 1990s. I loved tech investing, that is, until I (thankfully) realized in the late 1990s we were in a historic tech-driven bubble. I sold my last tech positions in late-1998, avoided all the damage from the tech bubble's collapse, eventually making money short (I [used] put options) and bought a good dozen tech stocks in October 2002 (near the lows). They were clear bargains then. However, I knew from history that after a giant bubble breaks, the prior leaders would likely become laggards. The next decade became known as "The Lost Decade" for stocks. The Lost Decade for stocks was a terrific bull market for precious metals, [for all the same reasons today]."

We have many of the same thoughts as Fred as we have overweighted precious metals positions – the environment is ideal for the metals and the mining and processing companies that produce them: the 2011-2015 bear market in metals led companies to replace prior managements with cash flow-oriented new managers who pay the most attention to finances and not "empire building" (which characterized mining companies pre-2011). The massive money printing post-2008 mentioned by Fred has led to inflation and the decades long fall in the value of the US dollar compared to prices of assets of all types. The relative scarcity of precious metals, with robust demand coming from central banks looking to build gold reserves as well as green energy and tech industries that are using a growing amount of silver and gold, respectively, underpin years-long demand growth. Meanwhile, supply has grown very slowly coming out of the 2010s bear market as rich ore bodies are much harder to find than in the past, leading to higher costs and relative scarcity of supplies.

In spite of all of the above, precious metals stocks have not yet realized big gains, but they continue to be extremely attractive cash generators, many with historically high margins and inventories of future supply that can keep growth in profits and cash for many years, with relatively high return of capital in the form of dividends and share buybacks making these companies even more investor-friendly. Their former (deserved) reputation of growth in size with financial success a secondary concern has kept many investors away from these companies. We believe their continued excellent financial performances and continued high demand for inflation protection and safe havens will draw more and more Western investors to precious metals and mining companies. As Fred relates in another part of his newsletter (not included in the excerpt), the 2001-2011 bull market in precious metals led to an 800+% gain in the price of gold and a 1760+% gain in the HUI NYSE Arca Gold Bugs [gold mining company] index from trough-to-peak, and that was a time of only moderately higher inflation! Thus, gold has recovered and hit new highs recently, but the stocks have not responded in kind, which we believe is imminent.

Bottom line: We continue to hold portfolios with gold and silver exchange traded funds as well as high quality gold mining companies with mines in mostly friendly mining jurisdictions (US, Canada, Mexico, Australia and Europe), mostly avoiding Latin American and Asian countries which have retraded ownership of mines lately or in some cases, seized mines "for the people." These mining companies have weakened in sell-offs twice in the past year as the US dollar spiked higher, but both times, the stocks have recovered strongly, and gold has recently fended off dollar strength, rising at the same time as the dollar and is currently around $2,000/oz. However, compared to the current size of worldwide money supplies and world bond markets, gold is at a far smaller value than in the 1970s, while inflation, monetary and geopolitical conditions are in a very similar consideration.

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Energy

Energy stocks were the runaway winners last year during an otherwise poor year for stocks, and this year energy stocks have continued their winning streak, albeit at a far more modest pace than last year. However, they have been held back by worries about demand in a world in which most investors see economic slowdowns accelerating. In the past, slowing economies have meant slowing energy usage, leading to price weakness and reinforcing the past cyclicality of energy prices. This year, the International Energy Agency (the IEA), formed in the 1970s by oil-importing countries to track energy statistics and forecast supply and demand dynamics, has predicted that fossil fuel usage will peak by 2030, and that the anticipated weakness could mean that demand could peak earlier and never recover past usage levels. Since many governments use IEA studies and forecasts, as do a number of international oil companies, there is some serious concern about further investment in oil and gas extraction projects as well as infrastructure (like refineries and pipelines, etc.). At the same time, the IEA has adopted a more progressive stance on rising usage of energy in general, in the form of renewables generating more and more energy for the increased usage of electric vehicles, but without specifying much detail about the massive amount of infrastructure needed to achieve such growth.

Having said all that, private forecasts have generally all pointed to both 2023 and 2024 showing growth in the use of fossil fuels and setting all-time records for usage of each. One of the latest forecasts from the Economist Intelligence Unit shows 2024 growth in global energy consumption of 1.8%, with oil, gas and renewables all showing growth, with renewables strongest at 11%. Oil growth is seen at 1.7% or 2.2 million barrels per day (bpd) in 2024. Opec recently estimated that 2023 oil usage growth reached 2.3-2.4 million bpd, totaling a record 102.1 million bpd usage, driven by continued increasing demand by China (in spite of their reduced economic growth rates).

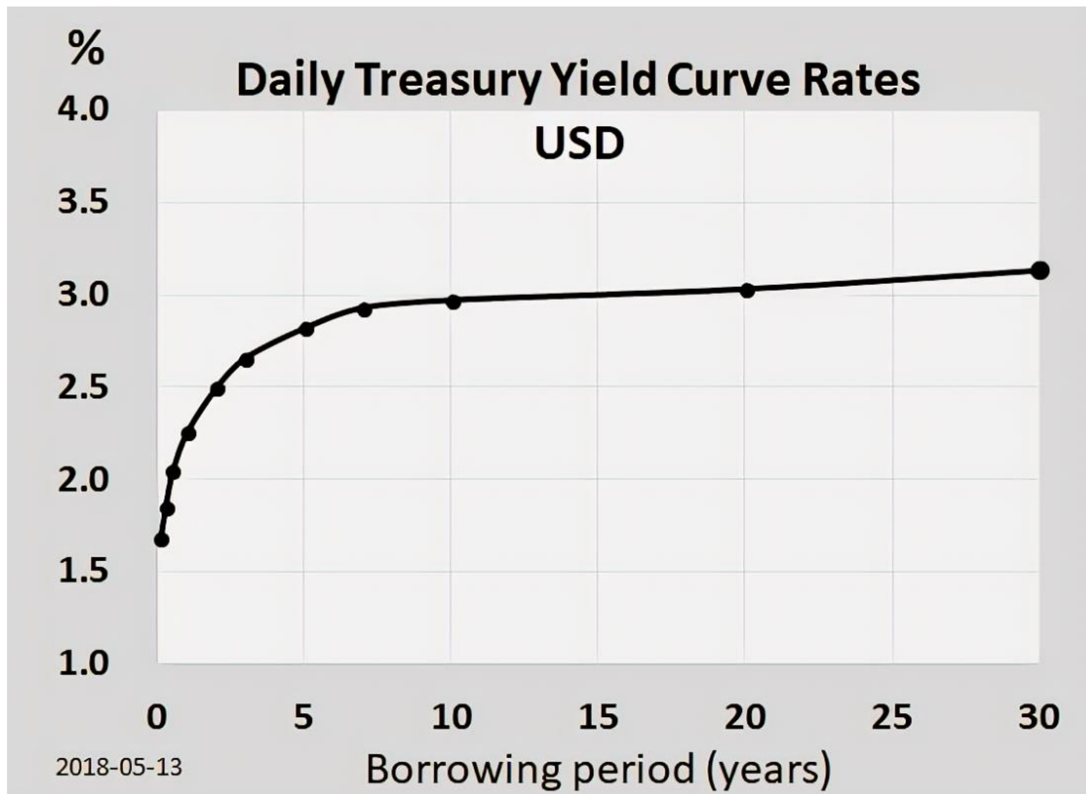
And the abovementioned IEA announced during the third quarter that global coal usage is expected to achieve record high demand this year, inching up 0.4% to 8.4 billion tons.

With these demand increases and expectations for further growth in usage in 2024 (and certainly beyond), we feel that our overweight in owning energy equities is justified. In addition to continued robust demand, war and geopolitical upset in Eastern Europe and now the Middle East has upset many transportation and distribution routes, if not any significant producing regions. However, the new geopolitical environment risks conflict between large energy producers and large energy consumers as supporters of different sides in Middle East politics, which currently only adds angst and war premium to current energy prices. Add in the Biden Administration's continued efforts to thwart any expansion of petroleum production or transportation, both domestically and internationally, and our portfolio of energy supermajors, E&P companies, refiners and pipeline companies should continue to prosper and reward shareholders going forward for a long time, politically-motivated demand forecasts be damned.

<u>Bottom line:</u> We own supermajors, exploration and production companies, refiners and pipeline companies, all of which continue to provide safe reliable energy supplies at market prices from domestic and international locations.

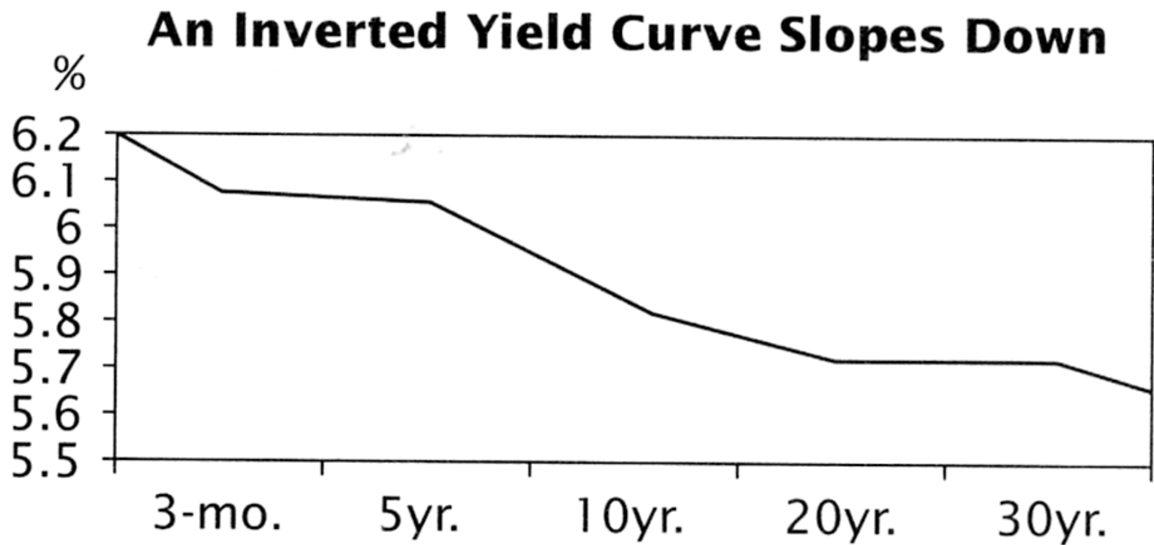
The Yield Curve and the Dollar – What Gives?

Here is a diagram of a typical US Government bond yield curve, with all the maturities graphed with the shortest on the left side and the longest-term bonds on the right side. This is important because all US bonds are priced referencing where the similar-term US Treasury is currently priced.



As this typical yield curve shows, as the bond maturity gets longer), the yield goes up – this generality is caused by a term premium buyers typically demand for lending money to the government for a longer term. There is less risk in lending for three months than lending for thirty years – a lot can happen in thirty years, and governments and economies and finances can change during that term. Typically the amount of change in three months is much smaller, hence less premium is needed to compensate for the risk. Some of the extra premium built in to longer-term bonds is inflation premium in case inflation flares up.

So, a yield curve is typically upward sloping, from the lower left to the upper right. However, there are times when investors in Treasuries will pay more for long-term bonds, when they anticipate that there will be future economic weakness. This situation indicates that eventually there will be a need to lower short-term interest rates, but they anticipate this, buying longer-term bonds/notes, which drives the longer-term interest rates down in relation to short rates, thus creating an **inverted yield curve.** A typical inverted yield curve is illustrated below:



When investors anticipate an economic slowdown, they bid up longer-term bonds compared to shorter-term bonds, which is said to **flatten** the curve. If investors anticipate enough of a slowdown, long rates drop even faster than short rates, flattening the curve further until it eventually inverts.

When investors decide to invest more in short-term bills/notes compared to longer-term bonds, this leads to a **steepening** of the yield curve, when long-rates move back to being higher than short-term rates, and this typically happens when the Fed lowers short-term interest rates to cushion the blow of a rapidly decelerating economy or an economy that has fallen into recession. Lowering interest rates (the Fed only controls very short-term rates remember) lowers financing costs for individuals and companies, allowing easier financial conditions and hopefully leading to an economic recovery.

So, with all of that said, lately, there has been a lot of discussion in financial circles of Treasury yield curves and the inversion that has happened among short-term bills and notes versus longer-dated Treasury notes and bonds.

One can construct a yield curve using a number of different combinations of T-bills, notes or bonds; we are going to use the yield on a 3-month Treasury Bill subtracted from the yield on the 10-year Treasury Note (the "3-mo/10-yr") for this discussion. This is just an interval of the entire yield curve, but the level of the 3-mo/10-yr curve has been a very good indicator for indicating investors' anxiousness over anticipated financial distress, so we are going to use this piece of the curve.

The 3-mo/10-yr curve has moved around as illustrated below in the financial chart, moving over time from being positively-sloped (above 0) to being negatively-sloped, as investors buy and sell each maturity, which moves this curve from negative to positive and back again during financial cycles.

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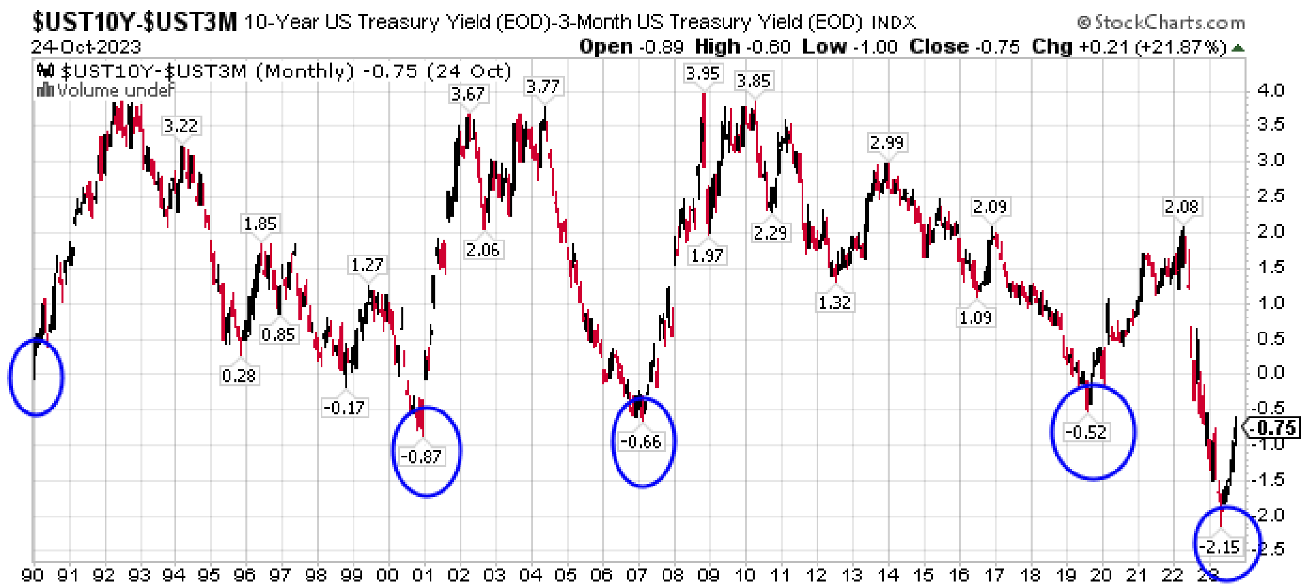

This yield curve has most recently been inverted since October 2022. Since World War II, a 3-mo/10-yr inversion of over 50 basis points has signaled that a US recession would occur sometime between six and twenty-four months in the future. The chart above shows the last five inversions of 50 basis points or more (the data for this graph starts in January 1990, so it doesn't show the 1989 inversion completely). Each of these blue circles represents an inversion that preceded a recession – the recessions occurred in 1990-91, 2001-2003, 2007-2009, 2020 and our current situation, which has not been called a recession yet, although interestingly, the inversion is the biggest in history, with a bottom at -215 basis points.

As this chart also shows, the lowest point of inversion also precedes each recession, with the yield curve steepening as each recession starts. We need to go through one more quick tutorial on yield curve movements to best understand the dynamics of today versus typical recessions.

When a yield curve is inverted and starts to un-invert, it is called steepening. But there are two ways that the yield curve can steepen: 1) short rates go down compared to long rates or 2) long rates go up compared to short rates. The first one is called a **bull steepener**: short-rates are lowered by the Fed (and the market through its buying), driving down short-rates in relation to long rates. This is what happens when an economy that has slowed down or is in recession starts to heal and get healthier; money has looked for safety during the recession, driving down short-rates as people pile in to super-safe, short-term Treasury Bills. Short rates, being very low, spur risk taking and companies begin to invest in new projects, keeping longer-term rates higher in relation to short rates, and the typical yield curve is restored.

However, the other yield curves can steepen is when longer-term interest rates rise in relation to short rates. This is called a **bear steepener** because interest rates going up are bearish regarding the value of the underlying bonds. This generally only happens for two reasons: a) the economy is very strong, and companies and individuals compete for longer-term money to finance attractive long-term projects or possessions, driving up long rates compared to short rates, which stay relatively high because of a booming economy, or b) long-rates are unattractive compared to short rates, and long-term interest rates must rise to attract investors who aren't willing to take longer-term fixed income risks without more compensation in the form of higher yields.

Unfortunately, the recent steepening during September and October has been bear steepening for the exact reasons mentioned in the last paragraph: investors are not willing to buy longer-term Treasuries unless they are better compensated. Why? The most compelling answer is that the US Government is deficit spending at a rate only exceeded during World War II and Covid, spending far more than tax receipts would support, and having to borrow the rest by selling more Treasuries. Thus, government spending is increasing the amount of Treasuries needed to be issued to cover the government's bills. In addition, recent inflation has caused investors to build in more premium to cover them for the risk of future inflation. That contributes to higher long rates. And finally, the Fed trying to slow down inflation and the economy post the huge stimulus issued to overcome the Covid lockdowns, has raised interest rates, driving up the cost of borrowing for everyone, but the federal government most of all. This increase in financing costs has contributed to <u>even more</u> Treasuries needing to be sold to cover interest costs.

The bear steepening occurring today shows short-rates staying at their current levels (5.25-5.5%), levels the economy hasn't had to sustain since 2007, and now 10-year Treasuries have risen in yield to 5% as buyers demand higher and higher yields to buy the large amounts of Treasuries being sold in auctions this fall.

As we mentioned at the outset, inversions occur when investors anticipate economic weakness, and yield curves start to un-invert/steepen when the recession happens – and we anticipate that the economy is either heading into recession currently or will be by early 2024. This bear steepener is hurting all past fixed income investors, whose bonds are being marked down due to rising yields and borrowers who must pay far higher interest costs if they are in floating rate loans, which is how most bank loans are structured.

Why does this matter? For a number of reasons:

1) Investors are telling the government that the amount of borrowing is excessive, and frankly, unsustainable, even for the wealth of the United States. This message however has not yet gotten to Congress and the Administration, both of whom think that spending is solely determined by agreement among lawmakers and not dependent on the fiscal condition of the government (poor) and the ability for the economy to grow and pay more in taxes (not great and getting worse);

2) Computer trading algorithms ('Algos') that large investors use to trade in markets have been driving up the US Dollar because they have been programmed that higher US interest rates means US investments are more attractive than overseas investments (higher yields attract worldwide capital). While this is true in a vacuum, as we said above, rates are going up because of the excessive supply of Treasuries, still-high US inflation and undeterred excessive spending by the US Government. None of these is good for the dollar ultimately, so we worry about the dollar rapidly losing value like it did after peaking last year, which could destabilize US financial markets and could lead to wider financial upset, especially after seeing the spreading geopolitical troubles around the world.

3) US Treasuries are considered ultra-safe. They are with respect to credit risk (the US is not going to default on paying them back), but they have shown that they were far overvalued and did contain a lot of downside risk when Treasuries hit 5,000-year lows in interest rates in the past few years (remember negative interest rates of the mid-2010s?). Now, post-Covid, with reignited inflation and excessive supplies of bonds for sale, bonds have continued to drop in value and holders are in line to have their

third straight losing year in the bond market – which literally has not happened since the 1780s. Bond losses hamper bank balance sheets (see Silicon Valley Bank et al) and hurts pension plans that must gather more assets or cut payouts when bond portfolios drop in value. "Zombie" companies that have issued very low coupon bonds in the past few years are finding they cannot refinance at any price that makes sense, and bankruptcies are on pace to be the highest in decades.

Thus, this yield curve inversion is shaping up to cause a lot more economic damage than has already occurred, as the world must deal with "regular" rates after being able to keep rates at centuries-lows and being able to run world economies with very low financing costs for years. With inflation comes the inability to continue this Goldilocks scenario, and financial markets will be in some turmoil until our economy reaches a new equilibrium that incorporates permanently higher interest rates, reasonable inflation and some government belt-tightening.

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