KANOS
CAPITAL MANAGEMENT, LLC

Fourth Quarter 2023 Investor Letter

Fourth Quarter Market Review

After a poor third quarter riddled with angst about the economy and the Federal Reserve's "higher for longer" policy, the fourth quarter was a barnburner characterized by the further moderating of measured inflation and the subsequent signaling by the Fed that rate hikes were done and lowering of rates was in the near future for the US economy. The resultant rally raised almost all assets, despite ongoing geopolitical conflicts in Ukraine and Gaza. Stocks bounced back strongly, led by the "Magnificent 7" large tech-oriented stocks, and this advance extended to many of the large cap stocks around the world. Bonds also bounced back with inflation moderating and the Fed (and other central banks) signaling future rate cuts. The US dollar was the loser, while commodities, led by an almost 12% gain in gold, advanced as economic optimism expanded.

Looking Forward

Introduction

After the big "everything" rally during the fourth quarter, investors, traders and analysts now have to face still-high interest rates in a slowing economic environment with geopolitical pressures and a muddled domestic political situation. To counter these forces, the US Government is hell-bent on spending as much as possible, so the fiscal situation for 2024 is underpinned by continued government expenditures and investments. However, even with moderating inflation, prices have not come down, and a large amount of US consumers are having trouble making ends meet, slowing consumption in a number of areas, leading many to see the current economic "malaise" conditions as a lead-in to recession. Countering this is still-high liquidity in the financial system, which is still flowing into the economy and into financial assets, so the stock market continues to advance.

Economy

The US economy is plodding along, bolstered by spending and investment by the US Government and some large companies, offset by lackadaisical spending by US consumers and a gradually slowing job market. Inflation has been trending lower, with current readings at a 3.4% annual rate (US CPI in December), while core CPI inflation continues to be stickier, dropping only to approximately 4.0%.

Continued high interest rates have reined in growth in some sectors; for example, housing has seen a slump during 2023 as mortgage rates priced many buyers out of first-time and upgrade real estate purchases after years of generationally-low mortgage rates. Yet, fourth quarter signaling by Fed officials that interest rates had peaked and were going to be cut in the near future have helped push down

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interest rates, with the hope that retail spending and especially spending on big ticket items, like houses, furnishings and vehicles, would pick up quickly from recent slumps.

The economic outlook, as indicated by recent Institute for Supply Management (ISM) surveys, show a manufacturing segment in a slump (ISM reading of 46-ish where 50 indicates the border between expansion and contraction) while strong ISM Services have slumped to a 50.7 reading, just barely expanding at this point. Prices Paid have continued to rise (inflation still in the system), while Prices Received have not kept up (waning demand leads to some price competition). The latest Fed survey, the Empire State (NY) Manufacturing Index, which rates the level of general business conditions in NY state, dropped precipitously to a -43.7 reading (0 is the line between expansion and contraction), the lowest reading since May 2020 in the depths of Covid lockdowns. New orders, shipments, inventories and employment all posted sharp declines – this definitely looks recessionary; this reading is below any Empire State readings during 2008-2009.

In spite of this, the US economy has so far avoided an official recession. Expanded government spending and investment have underpinned this continued expansion, with green initiatives under the IRA Act leading the way. Strong defense spending includes the US support of Ukraine and Israel in their current conflicts, the US military trying to go forward with current expanded worldwide operations and rebuilding stockpiles of weapons and ammunition. On the consumer side, retail sales have kept up with inflation lately, but are considered weak compared to other economic conditions.

Lately bond investors have been active in buying short-maturity Treasuries; in fact, 2-year T-Notes have rallied strongly, nearly un-inverting the 2s-10s yield curve. Before the last four recessions, the 2s-10s yield curve has un-inverted just as recessions commenced, so this un-inversion has been a recession indicator. The 2 yr-10 yr yield curve is pictured below, with the blue line the "0" line. The curve has gone from the most inverted since the early 1980s (last big inflation crisis) at -1.16% to flat in October and currently is a not-very-inverted 0.15%.

Europe appears to be on the verge of recession, as the ECB announced that rates may be coming down as inflation has moderated and economic growth has stagnated. Luckily for Europe, the winter has so far been mild, leading to moderated spending on energy, saving economic growth due to reduced

energy prices. Germany is already officially in recession, but the other countries have been able to continue slow growth, and the ECB would like to help countries maintain growth while trying to bring down inflation further.

Asian economies have been more resilient, although China continues to wrestle with reduced domestic and international demand, leading to deflation in consumer goods and weakness in China's enormous real estate sector, which has left their economy in the doldrums, compared to most other large world economies. India, Japan and many of the "Asian tigers" economies have shown economic strength, helping their markets and consumers prosper compared to many of the world's developed economies.

Bottom line: Economies have slowed throughout the world, but with measured inflation also moderating, central bank signals of lower future interest rates have led to continued growth in many of the world's economies. The Fed leading the charge for lower interest rates has led to some US dollar weakness, which has helped most international economies and more importantly, international markets.

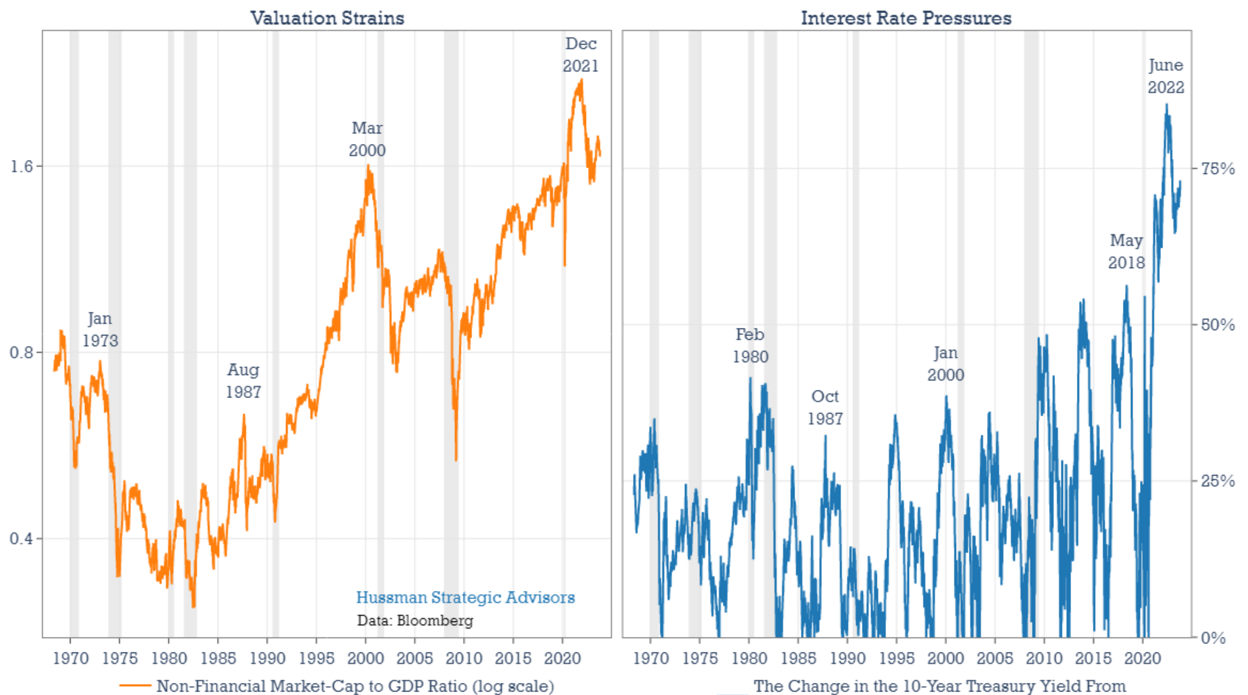
Equities

Equities are coming off a big fourth quarter after bottoming in October and shooting higher on the Fed pivot away from higher rates and the markets' euphoria over continued growth in revenues and lower future interest costs adding up to expanding earnings potential.

The Artificial Intelligence craze of 2023 has matured somewhat as companies actually introduce products using AI and others continue to spend heavily to train and develop systems to compete. Thus, semiconductor, cloud, software development and software services have continued to be areas of growing activity, boosting stocks in those areas or with interests that benefit from them.

Meanwhile, as mentioned in the Economy section, ISM manufacturing and services surveys point to slackening economic activity, while retail sales that are basically only keeping up with inflation show consumers are spending but not at any expansive pace. In spite of this, stocks have held up as Fed signaling points to lower financing costs for homes, large ticket items and credit cards going forward, leading stock investors to keep pushing money into the markets.

The fly in the ointment is valuations at this stage of the economic cycle. Most agree the US and most developed countries are at the end of the current economic cycle, with slow growth hopefully morphing into higher growth (the fabled "soft landing") without inflation reigniting. Current stock market valuations reflect this soft landing condition, with high valuations while interest rates have still not actually moved down significantly. The following chart shows the quandary:



The chart above, from William Hester's October 29, 2023 article "Seven Reminders While on Recession Watch" from hussmanfunds.com, shows that valuations are currently at their second highest ever (just below the December 2021 peak), even higher than the 2000 dot.com bubble. Meanwhile, interest rates are providing pressure due to their rapid increase in the last few months. In the past couple of months, interest rates have backed off their highs, alleviating a bit of this pressure, but the stock market has risen at the same time, increasing valuation strains. We think this is unsustainable and either valuations need to moderate (stock market backs off) and/or interest rates must continue to fall even further than they have, as the rapid increase in interest rates of the last two years has not been felt throughout the economy yet.

In addition, increased geopolitical upset most recently heightened by the Houthi tribe's virtual closing of the Red Sea to western shipping as part of the greater Middle East fighting among Hamas, Hezbollah, Israel, Iran, Yemen, Syria, Iraq and even Turkey points to supply chain upsets, higher prices and higher inventories, all risks to companies with high valuations and priced for near perfection.

Having said all that, US equity markets have been shrugging off international threats after geopolitical flareups and outbreaks of shooting wars have not affected developed world economies directly. Most Wall Street traders (and their international counterparts in London, Frankfurt, Paris, Tokyo and even Shanghai) "grew up" in the financial business as the Fed and other major central banks were a constant stimulative influence that added lots of liquidity and fixed "stumbles." The latest example is the bank failures of last spring, which were answered with a bazooka of liquidity made immediately available and the formerly "taboo" discount window was rolled out as a ongoing solution for banks' financial difficulties. We believe the constant central bank rescues, which could happen due to the then-structural lack of inflation (due to constant deflation of globalization), cannot be in the cards nearly as much in the future due to the now-prevalent inflationary pressures that can reignite due to geopolitical, supply chain or even labor unrest upsets.

However, we believe the financial markets maintain a "show me" attitude for increased geopolitical (and even inflationary) risks, which, in spite of the downdraft in 2022, continues to translate into a still-robust taking of risks in the financial markets. Thus, we expect to see markets continue to shrug off geopolitical threats unless they turn out to affect developed economies directly. The outperformance of the Magnificent 7 (Mag 7) mega cap tech stocks in 2023 left the other 'S&P 493' "underperforming" the S&P 500 index, the performance of which was dominated by the Mag 7 wild outperformance. Most investment portfolios were not overweight these expensive Mag 7 stocks and so underperformed the index, since in 2022, the S&P 500 was down -18.1% and tech stocks were down 28.2% (as represented by XLK, the S&P Tech ETF). In 2024, as tech stocks have shrugged off early January weakness and reestablished stock market leadership, it looks like FOMO (fear of missing out) by managers who underperformed last year will drive tech stocks even higher, led again (at least initially) by the Mag 7. The reopening of companies' buyout windows (companies are restricted by the SEC from buying back their own stock before and just after quarterly earnings announcements) is expected provide some additional tailwinds, as could seasonality, which predicts some January weakness usually followed by February strength.

We see a showdown occurring in March, however, when the bank rescue package, the Bank Term Funding Program (BTFP), expires. Currently there are over $160 billion in securities that banks have lent to the Fed in exchange for the par amount in cash to bolster banks' reserves and capital levels. The Fed has announced the facility will be discontinued in March. Thus, as of March 11, a number of small- and medium-sized banks will have to find new financing or possibly suffer the fate of Silicon Valley Bank and Signature Bank, failing due to a hole in their balance sheets and no one willing to step up to save them The Fed is providing the traditional Discount Window for emergencies, but the transition and/or the sheer amount need at the Discount Window could send shivers into the US financial system.

In addition to the BTFP, a Covid-era Fed facility called the Reverse Repo Facility (RRP) that allows banks to park excess cash at the Fed and receive Fed-owned Treasury bonds (and interest from them) may contribute to further Fed action this spring. After reaching a high balance of around $1.8 trillion in 2022, the RRP has dropped to under a $600 billion balance in recent days as the excess reserves have been drawn down and redeployed into Treasuries. The larger and larger amounts of recent debt issuance (mostly T-bills) due to the nearly $6.9 trillion of spending this fiscal year and large amounts of Treasury debt needing refinancing require larger and larger amounts of investor capital to finance. Increasingly, domestic sources are needed for this financing as China, Russia and the Federal Reserve of the US have reduced their holdings of Treasuries in recent years (the Fed's Quantitative Tightening sells the Fed's holdings of Treasuries, or at least let's them mature without reinvesting). Banks and other pools of capital earning interest with the RRP have moved capital to T-bills for higher yield, quickly draining the RRP and causing some concern among financial market analysts and Fed officials that excess reserves were being drawn down so fast that financial conditions might tighten more than the Fed would like and that the "financial plumbing" may not flow smoothly, just at a time when banks might have to be out looking for more capital due to the end of the BTFP. These two facilities will be at the forefront of Fed action this spring if they deem financial conditions too tight, which would have a large effect on the US stock market as well as credit markets.

World stock markets are in a similar shape – hoping for continued consumer growth but facing recessionary conditions in Europe and China and some growth in India, Japan and other Asian, Latin American and African countries. All are expecting central banks to react to falling inflation statistics and

the rhetorical lead of the US Federal Reserve to plan and announce how rate cuts will occur, presumably soon. This has led to some gains

China has not been able to kick start their market as their economy and real estate markets continue to sputter. Not only has Foreign Direct Investment (FDI) dropped as companies redeploy manufacturing to other east Asian countries, like Vietnam, and to Mexico, but investors have withdrawn their investment dollars too, as the US, India, Japan and other markets perform better and reflect better future fundamentals. Thus, the Chinese market has notably underperformed for months and has been reaching new multi-year lows in January. The latest breaking news is that China's "National Team," their "plunge protection team" in the finance ministry of the government which buys stocks and bonds in the financial markets in case of emergency stepped in and bought ETFs in the Chinese stock market on January 18, 2024, arresting a break to new lows in market averages that threatened to get far worse.

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 that show attractive fundamentals, financial ratios and price action. 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 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 continues to be led by a few mega-cap tech stocks and semiconductor firms which have reignited interest in the stock market, overcoming early January weakness. We see seasonals and buybacks sustaining market gains into February but believe the market could see turbulence in March as banking/financing concerns impact financial markets. The risk of higher interest rates caused by stock market investor shifting from recessionary expectations to a greater chance of a soft landing may limit gains in stocks. If inflation starts to climb again (as it did in December), stocks could also stumble as traders and investors push down the Fed's tendency to lower interest rates at the currently aggressive rate of 6-7 cuts during the year. We expect to stay relatively fully invested, looking to shift into more aggressive investments if the March financing issues are solved successfully. We would also like to diversify some of our investments to more international companies if the economic outlook starts to look more favorable. Our current strategy of using US-traded companies for international exposure has worked well, but international companies are cheaper and could present more attractive opportunities in the future if economic conditions improve.

Bonds

US bonds slid into October, reaching multi-year lows (highs in yields) but since rebounded strongly. With the Fed signaling lower short-term interest rates in the future, short-term bonds have increased in value relative to longer-term bonds, which still require higher interest rates to attract incremental buyers. Generally, yield curves like the US' "un-invert" as the economy goes into recession, as short-term rates drop to try to incentivize increased economic growth as the economy stalls – if history is any prologue, this means that the US economy is going to slide into recession during the first quarter.

While in the past this might be a good time to buy some bonds (probably 2-5 year maturities) to try to profit from capital gains from dropping yields (and thus rising bond prices), the extremely high spending by the Biden Administration is causing huge deficits that are driving the US national debt higher at increasing rates, making it harder for the Treasury to sell all the additional debt and leading to some pressure on rates higher for government bonds. In addition, while measured inflation has dropped over the past 18 months, December reading showed some small increases in inflationary measures. Anticipated further rises in inflation, coupled with huge supplies of government bonds coming to market over the next few months, continues to make bonds seem unattractive except for short-term bonds for cash needs or for short-term investment horizons.

Corporates, especially high-yield bonds, have performed very well, much better than we expected. While interest rates have stayed high compared to recent years, and higher interest rates have attracted capital to higher-quality bonds, economic optimism and continued higher risk tolerance has kept investors buying high yield bonds as well as investment grade corporates. Many investors have stayed in/added high yield bonds, generally favored by investors over stocks due to their higher current yield but their equity-like appreciation. We don't share the market's risk tolerance because we are concerned about the rollover risk for many high yield bonds, which refinanced during depressed interest rate times during Covid lockdowns, but will face the task for refinancing during a time of heightened risk as well as higher interest rates, which when combined with their lower credit ratings, could shut out some borrowers from getting refinancing at all (or even at ruinously high interest rates) which could lead to default and/or restructuring/bankruptcy.

International bond markets are slightly more interesting, but also face refinancing risk and heightened geopolitical risks, meaning there are credit, sovereign and liquidity risks going forward. We have been less interested in most bond markets because of the increased risk of continued (or more probably, rising) inflation, so we currently are not looking at international bonds for our investors.

Bottom line: We still believe that the inflation, credit and supply/demand risks in bonds outweigh the rewards in the US and internationally, so we will not be in the market for bonds in the near future except to invest cash or for short-term time horizons. Bonds currently in investor portfolios are being allowed to run off to reinvest in more promising asset classes.

Currencies

After falling to a multi-month low in late December, the US dollar has rallied back somewhat as markets slumped at the beginning of January and geopolitical risk pushed traders to park capital in US dollars / US short-term bonds. However, just as the bond bounce back has lost some steam, the tepid bounce in dollars looks to be short-lived. We continue to expect the dollar to weaken for the same reason we are underweight bonds, so we are avoiding additional dollar exposure.

Having said that, the Japanese yen, which had been rising for much of late 2023 has stumbled lately as Bank of Japan chief Ueda has yet to end QE and has caused the yen to fall off in price recently. We expect the BOJ to toughen its stance, stopping its monetary stimulus and causing the yen to strengthen, possibly appreciably. However, we will not be putting any capital to work in such an idea until we see the BOJ move and understand their strategy.

The ECB has been a follower for the past couple of years, and things have not changed. Germany is experiencing recessionary conditions but inflation, while moderating, is still not down near the ECB's target range, so the euro has not strengthened much against the dollar lately and is not attractive to us currently.

China's central bank, the Peoples Bank of China (PBOC), has been applying bits of stimulus to the Chinese economy to try to ease financial conditions and get growth rebooted, but the yuan has pretty much stayed at the same levels against the dollar in the past few weeks.

Bottom line: The US dollar is in a countertrend rally, but it looks to resume a downward trajectory. The yen and euro, assumed beneficiaries of a weaker dollar, have moved relatively little as moves in monetary policy have been slower than expected. None of the major currencies have much attractiveness currently, and we will not be allocating capital to them at this time.

Commodities

Commodities have had varied performances lately. Metals, both precious and base, rallied during the fourth quarter but have corrected somewhat during January. Agricultural commodities had a poor fourth quarter but have bounced back a bit during January. Why the difference in performance?

Gold had a good year (+13%) helped by central banks adding to their gold reserves again during 2023. After a record 2022 for gold purchase, the World Gold Council said central banks bought 800 tons of gold through the first three quarters of 2023, a 14% increase over 2022 while banks added an additional 42 metric tons in October 2023. China bought 23 metric tons in October to bring their ten-month 2023 total purchases to 204 metric tons, according to SchiffGold (these are the publicly acknowledged purchases – many believe China is buying additional gold and not reporting it to international organizations). Poland's central bank added 6 tons in October to bring total 2023 purchases to-date of 100 metric tons. Sellers have been central banks in Turkey, Uzbekistan and Kazakhstan. We expect bank buying to continue as countries less friendly to the US or who have very little gold (most Western central banks) accumulate gold as the dollar is reduced as the primary central bank reserve currency, and banks adopt a portfolio approach of reserves.

Many investors don't realize that gold has outperformed US stocks since the early 2000s. As the graph below shows, gold outperformed stocks starting in the mid-2000s, with stocks (as measured by both the S&P 500 and the Nasdaq) only catching up in 2021, but then falling behind again since. We believe gold has been consolidating its gains over the past couple of years and is poised for another leg upward presently.

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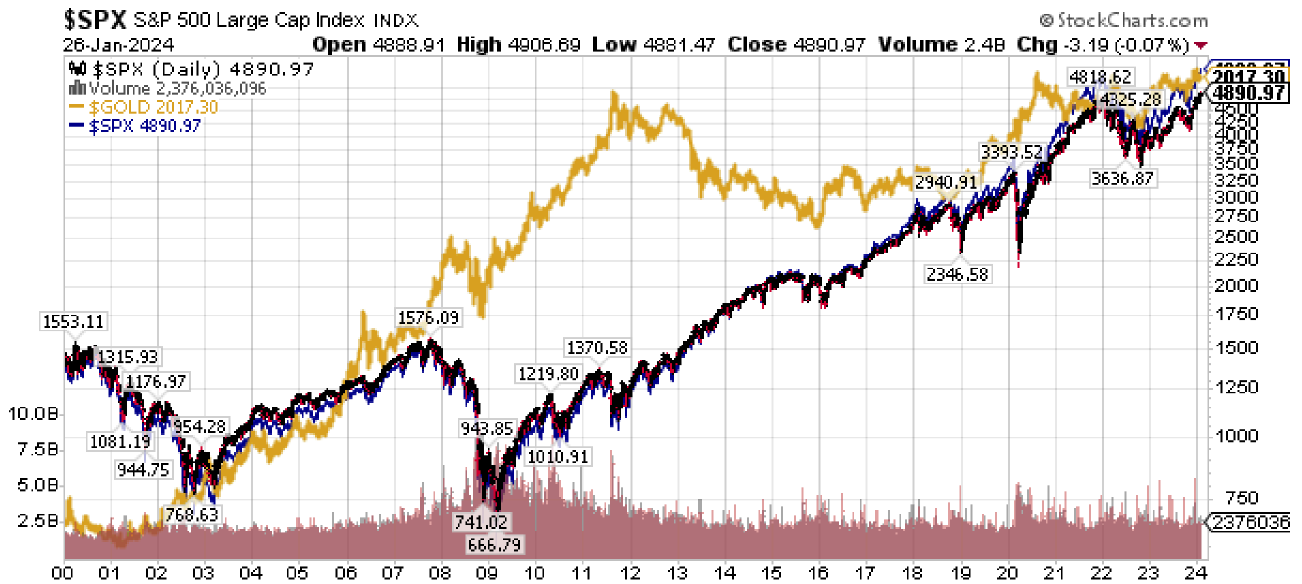


Precious metals mining stocks have not performed as well as gold has in the past few years. Western stock investors are the buyers of stocks like mining companies, and as 2023 was a year featuring big tech stocks, precious metals mining stocks underperformed gold (only up +6%) but were still positive. Their fundamentals, however, are excellent as mining companies were forced to get "lean and mean" after the last bear market of the mid-2010s. Thus, labor, fuel and other operating costs have been managed well while gold prices are just under all-time highs. Silver is an excellent conductor and has been in supply surplus in the last couple of years, so we expect more silver to be incorporated into the electric vehicle / charging infrastructure buildout just as supplies tighten up, pointing to higher prices in the near future.

Base metals, led by copper, had a down year as the Chinese economy struggled to grow, especially in manufactured goods and real estate. Copper as well as iron ore appear to have bottomed, and both have been in a slow upward trajectory since then. In addition, base metals producers are essential to provide the materials for the myriad of needs in the world's buildout of electrical vehicle (EV) infrastructure, from the plants for cars, batteries and parts, to the additional electrical grid infrastructure (wires, transformers, poles, etc.) to charging stations to battery backups of all types. Much of this is already in the planning stages due to US Government legislative activity of the past few years, so the demand will continue to build, regardless of the sluggishness of current US EV sales. Our big base mining stocks held up pretty well during the fall and rallied into the end of the year, but they have stumbled a bit since, as Chinese growth still seems anemic, as best signaled by Chinese equity markets, still stuck in a relentless, months-long bear market. However, China's ambitions hinge on keeping its populace economically optimistic, so we expect a parade of Chinese stimulus measures (which have already begun with lower bank reserve requirements and liquidity adds by the Bank of China) that will buttress further infrastructure construction and thus, demand for base metals and other materials.

Nuclear power has crept back into energy discussions, and with supplies of uranium sourced in many cases from unfriendly nations/environments around the world, uranium prices have risen for the last couple of years. We have some investments in uranium but may be expanding those holdings at attractive junctures.

Agricultural commodities ran up with inflation and the dire geopolitical threats to food supply chains when Russia invaded Ukraine in February 2022. However, despite the ground war and occasional sea

battles, grains and other foodstuffs have continued out of Ukraine and Russia, averting any long-term shortages while the recent El Nino weather occurrence has led to less grain production upset than originally thought, driving down prices to pre-war levels. We continue to monitor geopolitical and weather effects on these investments to see whether we will maintain them or move capital to more attractive prospects.

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, African and Asian countries. We still like and hold base metal miners that are major suppliers as the world builds out electric vehicle infrastructures over time. We may be buying more uranium investments over time. We hold fewer agricultural investments as the rewards due to elevated geopolitical risks seem to have moderated, leaving us to move capital to more attractive situations.

Energy

Energy was the worst performer in the fourth quarter as demand concerns trumped geopolitical upsets/worries and any supply concerns. After hitting multi-month lows in mid-December, crude oil prices have rallied in January as have gasoline and heating oil/jet fuel prices.

Despite heightened geopolitical risk as missiles fly in various locations around the Middle East, threatening expansion of the Israel-Hamas conflict, traders and investors have been complacent, expecting plenty of supplies able to be transported successfully while demand is the big question. Markets continue to think a moderation of demand will allow prices of all energy products to stay here around pre-war levels. However, even the International Energy Agency (IEA), the energy analysis organization for OECD Developed Countries, expects another 250,000 bbl/day growth in worldwide demand in 2024, over and above the record worldwide demand experienced in 2023. OPEC is even more bullish according to its Monthly Oil Market Report; it expects 2.2 million bpd growth in 2024 and an additional 1.8 million bpd in 2025 while supply growth is expected at only 1.3 million bpd. Thus, there is a quandary around demand – is it stalled or will this predicted growth, mostly from developing nations, drive prices higher as supplies have a harder time keeping up with constant growth?

One way to gauge the oil markets are whether oil traders believe demand is increasing or decreasing. This can be done by watching the "shape of the oil price curve" similar to the yield curve. By comparing the prices of oil (and other energy products) at various "vintages" in the futures market, one can try to determine the aggregate market reactions to events and news and see if demand seems to be increasing or decreasing. The easiest way to estimate this is to determine whether the market is in "contango" or "backwardation." Contango is when the market is priced more expensively through time, and generally the "prompt" or current deliveries are the cheapest. In contrast, backwardation is when prompt and/or front months are more expensive than later months prices, meaning that traders/users/ refiners are bidding more to get oil presently or in the near future, showing increasing demand.

With those concepts in mind, the WTI crude oil market was trading in the fourth quarter in an over $2.00 contango, where February was more than $2.00 cheaper than March, showing the futures market thought demand was very slack and that storing February crude made more economic sense than refining it. By the end of 2023, that gap had closed to less than $0.25 per barrel, and in mid-January, Feb-Mar went into backwardation. As of the last week of January (the February contract is already off

the board), the near-term spread between the prompt March 2024 WTI and April 2024 WTI is 15 cents backwardated, and the oil curve is backwardated in every month out to July 2025! Thus, in spite of recent bearishness about demand, the oil curve is now pricing a noticeable in demand for crude, and crude being in the lower end of the band of $60-$90/barrel of recent months may be over.

We also think that more growth will come out of developing countries than is anticipated as prices are historically "middle of the range" and waning US dollar strength makes oil more affordable in dynamic growing economies. Governments are intent to have growth as strong as possible, and petroleum products and natural gas deliver the most energy dense power needed to fuel vehicles, supply power grids, heat homes and supply cities' growth.

Coal will continue to be a solution as well, especially in India and China. Chinese coal production just hit a record-high level of 4.7 billion metric tons in 2023, a 2.9% increase over 2022 according to their National Bureau of Statistics. In addition, China's increased demand had them import an additional 474 million metric tons from around the world during 2023, a 62% increase. India's usage is approximately 900 million metric tons but expected to rise at nearly 8% per year to reach 1.4 billion metric tons in 2029. US firms are a big source of exported coal as usage continues to grow worldwide despite opposition from green groups.

Bottom line: 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. We own some select coal producers and may increase our investments in these generally cheap investments. Our investments are picked for their potential for capital gains, current yield and possibility of acquisition by larger entities. Fundamentals are still very attractive, and we expect energy investments to outperform again in 2024 and beyond.

Inflation and the Future

Since last fall, the US stock market has been rallying on Fed messaging that rate hikes are a thing of the past as a result of the drop in measured inflation rates over the past year. Thus, many anticipate the Fed lowering rates sooner rather than later due to inflation falling back to their target range. To recap, after reaching as high as 9.1% late last year, inflation as measured by the CPI has dropped as low as 3.1% in November (although bouncing back to 3.4% in December), while core CPI has remained stubbornly around the 4% level (December core CPI at 3.93%).

One main cause of higher CPI readings in 2022 and lower CPI this year is what's known as the "base effect": low levels of 2021 inflation changed to very high readings in 2022 as new, higher prices were compared to the prior year's prices before massive stimulus, pent-up consumer demand, a labor shortage and the Russia-Ukraine war, caused a massive rapid jump in prices and thus inflation. This year, energy prices are down significantly, and other commodities are far lower than their early 2022 peak prices, causing inflation readings to moderate, thus causing disinflation (lower rates of inflation) due to the base effect in reverse.

So, what can we project going forward? Inflation has been at the forefront of investors minds since the Fed blew its "transitory" call, inflation ballooned and the Fed followed with its fastest rate increase dosage in history. Pundits in the media and Biden Administration-supportive economic analysts continue with a drumbeat of falling inflation due to the lack of new stimulus and the plentifulness of commodities in spite of the two large geopolitical conflicts occurring currently. As of now, "the trend is their friend," as inflation reports continue to show a continuing moderation.

Unfortunately for all of us looking "under the hood" of inflation reports, it seems like we've seen the big drops. One measure Fed officials have been tracking is the "Core CPI Services Ex-Shelter Index" or what some call the "SuperCore" rate, which tracks the core inflation measures but leaves out food and energy (to lessen month-to-month volatility) and shelter (some consider it too lagging an indicator). This index has been rising for the last few months, registering over 4% for the first time this fall and rising another +0.4% in December (the last reported data). In addition, the CPI Shelter component of the index continues to be reported at higher levels than other inflation, registering a 6.2% annual rate in December (although at its lowest annual rate in 18 months). Food Away from Home rose at a 5.2% rate in December too, showing food inflation is still in the system despite grains and other ag commodities being far off their wartime highs.

What concerns us most, however, are the structural elements that have caused inflation to occur in the first place. Rising wages, geopolitical upsets, supply chain troubles, supply shortages and lack of any cost relief for consumers are ongoing, and we believe are entrenching future inflation.

Wages in aggregate have not even kept up with inflation: costs in general are up 21% since 2020, while aggregate wages of production and non-supervisory jobs are only up 17%. However, wage earners have now gained more leverage to bargain for higher wages, the most leverage in at least thirty years, meaning wage inflation is probably not dropping any time soon, in spite of tepid economic growth that could easily turn into recessionary conditions – why? Start with President Biden's executive order that raised

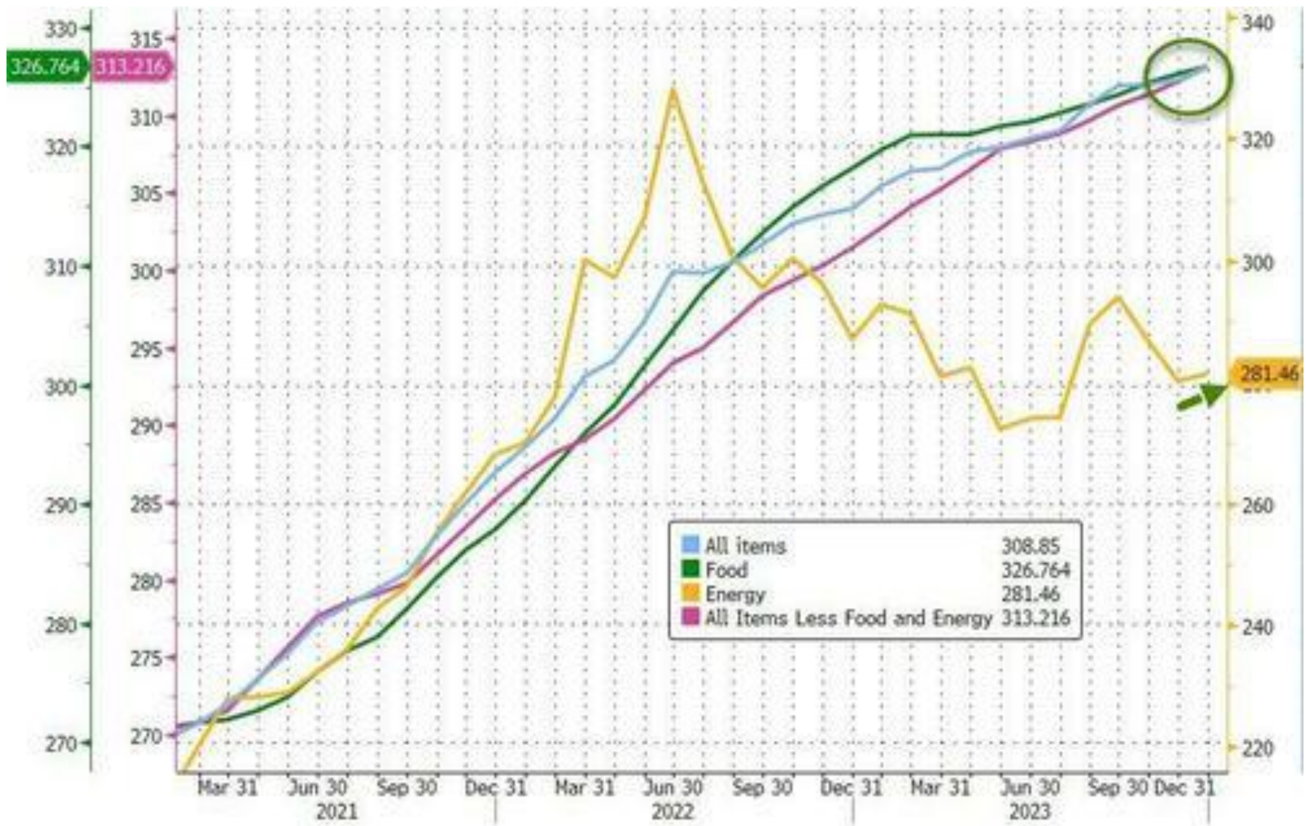
all federal salaries 5.2% for 2024. Exhibit B are the recent deals negotiated by car company employees, airline employees, etc. where wage gains are locked in for the next few years at rates that catch up for past "underpayments," meaning these contracts will inject costs at higher than prevailing inflation rates. In addition, high interest rates have cut down the attractiveness of using capital over increased labor. Thus, labor has gained back some attractiveness versus new capital expenditures, giving employees more leverage.

Geopolitics has replaced lockdowns as a big cause of supply upsets. Not only has the Russia-Ukraine war upset energy markets, with much of Russian energy products off limits to much of the developed world, even non-war events are leading to shortages and thus higher costs. The West, led by the US, has denied China advanced semiconductor equipment and products, and China has lately retaliated with a ban on exports of some rare earth minerals, used in hundreds of high-tech products and military hardware. Meanwhile, actual war conditions have closed the southern Red Sea to shipping from the West, as the Houthis of Yemen shoot missiles and drones at Western tankers and cargo carriers, causing shipping to have to reroute to an almost twice-as-long route around the Cape of Good Hope in South Africa. This disruption causes more time, more operating costs (container shipping rates offered by carriers have doubled since Houthi attacks started in December) and higher piracy risks in some areas off southern Africa. In addition, insurance rates have skyrocketed while in some cases insurance is being denied for war-threatened routes in the Red Sea (Mideast) and Black Sea (Russia/Ukraine). All of these shipping risks/upsets add time and costs to goods, raising their landed costs, putting inflationary pressures on consumer prices. Note from the past: Egypt closed the Suez Canal from June 1967 through June 1975, and what happened to prices during that time? The Great Society/"Guns and Butter" spending stoked inflation during the Johnson Administration and then the first Arab oil shock in 1973 almost tripled energy prices, leading to years of high inflation and resultant high interest rates. There are many similarities to today's situation.

Supply chains, while healed somewhat from Covid-period upsets due to lockdowns and demand spikes, have started to see hiccups again. Starting with national security concerns (and in response to those), trade and shipping of semiconductors, rare earth minerals and other advanced electronics have been restricted due to "hot war" and "cold war" concerns among Russia, China and the developed world. "Mischief" by countries trying to make trouble/gain advantages has caused transport upsets not only in the Black and Red Seas but also in the South China Sea, where China is in near-shooting war conflict with the Philippines and Vietnam over islands that China has claimed and built into military bases. Meanwhile, bad weather (drought) has limited shipping through the Panama Canal, further lengthening shipping times in the Western Hemisphere, adding to shipping disruptions, especially in light of the Red Sea troubles.

Last, but certainly not least, inflation is the rise in prices over time. While inflation has moderated, this means that prices have risen less quickly than before – but they're still rising. As a stark illustration of this, Bloomberg tracks various costs in the US economy. In its recent reading on January 11th, when December 2023 consumer inflation statistics were released, the aggregate cost of consumer items, the All Items category, was at all-time highs. Food costs were at all-time highs. Energy was far off the mid-2022 highs but rising again. Meanwhile, All items less food and energy were at all-time highs. Thus, while the inflation rate has moderated, costs borne by US consumers are at their highest in history and don't appear to have any relief on the horizon.

2 charts illustrate this well:



The above chart from Bloomberg on 1/11/2024 shows prices since the beginning of 2021. Despite Energy prices being 13% off their mid-2022 highs, prices of Food, All Items and All Items Less Food and Energy are all at all-time highs. This is a good illustration of how people are still feeling the pain of inflation on a daily basis.

This graph above of CPI prices from StockCharts.com shows the Consumer Price Index from 1990-2023. One can see that while inflation was relatively low from 1990-2020, prices have still risen nearly

3x from 1990, and one can see the even-steeper upward trajectory of prices during the latest bout of inflation starting in 2020 on the far right side of the graph. Even as inflation has "moderated" starting in mid-2022, you can see the slope of the price index from mid-2022 to end-of-2023 is still steeper than the slope of the price curve during the 2010s. This also shows why people are still mad about inflation – prices have not come down lately, just risen less quickly.

We will be investing your capital with the above elements in mind.

What happens after November 2024?

We have literally felt the angst of building pressures in politics, economics and culture that seemingly will culminate with the election in November 2024. Not only are the political ramifications looming very large, so are many economic situations. We think it is worth thinking about some of them and ruminating on possible solutions:

1) **Fed Policy:**
   Pre-election consensus – Currently, the financial markets' consensus is that the Fed will start easing interest rates in March 2024 since measured inflation has waned. In addition, general thoughts are that the Fed is supportive of the current Administration and will not be hawkish at all in an election year (this is a historical situation that has effectively occurred for most administrations over the past few decades since the early 1980s).
   Possible pre-election variance – If inflation fails to drop further or stays at current levels, the Fed will be in a quandary – how to continue to fight inflation but not hamstring the economy or even send it into recession? A) if inflation doesn't moderate but the economy hangs in there, we think they will continue to "talk a good easing game" constantly but not lower interest rates as fast as the market would like. B) If the economy starts to deteriorate, we think the Fed will lower rates relatively quickly in spite of inflation, using the "power of the pulpit" to say "inflation will drop as the economy bottoms." We find this scenario to be the most probable with recessionary forces slowly building.
   Post-election – Unfortunately, we believe this is different depending on who wins the US Presidency. If Biden wins, then we think the Fed returns to its current stance, getting tougher on inflation to try to knock it back down to its 2% target, which could involve rate hikes or fewer rate cuts than expected over the next couple of years. If Trump wins, we believe the Fed will be much more hawkish (as former New York Fed chief Bill Dudley advocated soon after leaving the Fed's second-most powerful position), which will make it harder on the President but will fight inflation in a more pronounced and healthy way.
   Confidence – we feel very confident in our predictions around the Fed, who is unfortunately very predictable despite their attempts to say they are almost always data-dependent in their decision making.

2) **US Government fiscal policy:**
   Pre-election – This is the easiest prediction on the board. The Biden Administration, even with a Republican Congress, will continue to spend on its already determined fiscal path, causing the largest non-wartime deficits outside of Covid. This increased government spending keeps money flowing but also continues to provide a tailwind to inflationary pressures as the government adds to private spending and investment demands.

Possible pre-election variance – We don't think spending will vary, even if the economy deteriorates. Election year politics are already pretty dialed in, so the desire or ability to change is almost non-existent.
Post-election – This is also relatively path dependent, as per election results. If Biden wins, his administration will take the win as validation of his policies and spending will continue as before, although probably not as frenetically as has occurred during 2023-24. If Trump were to win, we believe he would probably have a Republican majority in the House, meaning spending would be changed radically, although it may not be reduced materially. Thus, we see spending moderating but not plummeting if Trump is elected.
Confidence – as in our Fed prediction, we feel pretty confident that spending will continue at the highest possible level available for political purposes – it's the habit that US lawmakers have gotten into that will be hard to curtail.

3) **Interest rates:**
Pre-election – The credit markets are currently anticipating around 5-6 rate cuts during 2024, twice what the Fed has signaled in their "dot plots" they release every three months with their "predictions" on where they think interest rates will be for the 2-ish years. Starting in March, markets see a quarter point rate cut at most meetings during 2024; we believe that is because the markets see recessionary conditions continuing to build and the Fed will be forced to be more accommodative so that the economy doesn't go "into the tank."
Possible pre-election variance – The current thinking could be disrupted if inflation doesn't come down sequentially during 2024 (we feel like there is a good chance that it won't do so). Also, interest rates will be affected by how the Treasury decides to fund its current needs, which is announced on the first Wednesday in February, April, August and November. How much will continue to be financed in T-bills is a big question, and as the RRP continues to be drawn down, it could affect interest rates as the bond market struggles under huge supplies of Treasury debt to be sold. In addition, the expiration of the BTFP in March will cause some waves in the banking sector, and if things don't fall the right way, we might get a reduction of QT, or possibly even a hint from the Fed of an eventual return to QE (if things get sideways). Liquidity is a concern for the Fed – the expiration of the BTFP and the draining of the RRP are both events that lessen liquidity. If liquidity in the daily money markets or the selling of Treasury debt becomes a problem, then the logical progression is to reduce QT, and if that is not enough, instituting QE once more, with the Fed buying targeted maturities of bonds to make sure the market is functioning and to limit yield from climbing too much (and causing financial problems, in addition to the liquidity problem). It is a serious concern since future Treasury supply could be big enough to get bond buyers concerned that all the debt can be auctioned.
Post-election – Once the election is over, we think interest rates probably go up, regardless of who is elected. We think inflationary pressures continue to build while spending does not fall appreciably, needing more and more debt to be auctioned by the Treasury. In addition, lots of corporate borrowers locked in very low rates post-Covid when rates were at generational lows; this debt will need to be refinanced in the next 1-3 years, adding to the supply for bond market buyers. Again, many in the markets are already whispering that the Fed will need to reinstitute QE to make sure there is a buyer for all the debt coming up for sale. An announcement of QE could push down interest rates, but ultimately, QE will up inflationary pressures as lots of new money is introduced into the US and world financial systems, so it could backfire and cause interest rates to jump as buyers try to angle for cheaper prices for bonds by holding out for higher interest rates, especially for non-investment grade borrowers.

Confidence – Our confidence in these interest rate prognostications is clearly dependent on certain paths, but we have seen earlier in the fall of 2023 that bond yields stayed stubbornly high as bond market participants were clearly worried about supplies of Treasury and other US bonds, keeping yields higher than the market expected. The wild card is the Fed's possible reduction of QT/use of QE; the Fed's sunsetting of its QT program will almost certainly happen in 2024 as excess reserves in the US financial system continue to drop.

4) **US Stock market:**
Pre-election – This is probably the hardest call on the board, as there are many reasons for the market to go up or go down. Reasons for the market to advance are: 1) still plentiful liquidity, 2) momentum and seasonality, 3) Fed signaling easing, 4) government spending robust, and 5) US a haven for investment in times of war. Reasons for the market to drop are: 1) high valuations, 2) high interest rates with large amounts of refinancings approaching (Treasury & corporates), 3) worries about bank balance sheets, 4) waning economic vigor/earnings concerns, and 5) lingering and possibly building inflation further sapping the economy. Odds are that we have drops in the market interspersed with rebounds that lead to a choppy but largely unchanged market by election time.
Possible pre-election variance – Like recent years, the market could be affected by externalities, especially war escalation, war resolution (Ukraine seeking peace?), more bank failures, Fed instituting QE for liquidity or supporting the financial system (as happened in 2019 with no prior warning), death of a candidate (they are both very old), etc. Too many possibilities, but as we said above, a slightly higher year when the election arrives?
Post-election – If Biden wins, we think the market will perceive four more years of government malinvestment in green initiatives and further mismanagement of Democratic-led states and cities and will price in a poorer economic future. If Trump wins, we think financial conditions will tighten and bureaucratic gridlock (to try to prevent reversal of any of the Biden Administration's projects) will lead to an inability to revive the economy fast enough, so that the country experiences all the symptoms of a recession.
Confidence – With so many variables that could affect the direction and magnitude of changes in the US stock market, we have low confidence that we know which factors will come forward to affect the markets. However, we are confident that we understand the risks and possible reward trajectories so that we can adjust our portfolios to changing market situations as they present themselves.

5) **Foreign stock markets:**
Pre-election – As Europe and China slide further into recessionary conditions and slowing growth, respectively, we see conditions abroad continuing mostly on their same paths. While the Ukraine situation could be resolved in the next few months, lessening geopolitical risks/angst, especially in Europe, we see the Hamas-Israel-Hezbollah conflict continuing to reignite time and again at least through 2024. These conflicts will continue to hinder worldwide growth but allow for some countries to take advantage and grow, most notably India and most East Asian economies excluding China.
Possible pre-election variance – not applicable
Post-election – We think this could actually be very election outcome-dependent. If Biden is reelected, we think that we see more of the same, and possibly additional hotspots flair up, probably further driving down worldwide growth (due to rising costs) and thus probably stock prices, as European malaise turns into outright recession. However, if Trump wins, we can see that he might reach out to Europe and the Middle East to try to broker peace initiatives, and this

could lead to rallies in worldwide markets, especially if the ECB and other banks try to revive their economies with rate cuts.

Confidence – Our confidence in predicting foreign markets is also low, because their direction and magnitude of changes are path dependent on peace initiatives and election outcomes. However, as we said above, by gaming possible outcomes in exercises like this, we believe we can readjust portfolios to capitalize on attractive opportunities as they present themselves.

6) **Inflation:**

Pre-election – Although measured inflation has been registering smaller numbers until December, the last bit of inflation is usually the stickiest. Thus, if energy prices rise going forward, which the Biden Administration is actively trying to suppress (by encouraging every oil-rich dictator to play ball with the Administration and produce as much as possible), we could see a pick up in inflation statistics during 2024. More probably, the statistics will show small changes that steadily work toward the 2% goal.

Possible pre-election variance – As addressed above, a spike in energy prices or a more major geopolitical flareup could cause a jump in energy and/or other commodity prices, as well as further elevating transportation prices, which could jump inflation higher. Seems like there's little chance that inflation could plummet in the next few months, but you never know in this environment.

Post-election – The election results could have an immediate effect on inflation, as a Trump victory would drive people to the conclusion that at least the Ukraine-Russia war would be ending, lowering geopolitical angst somewhat and probably bringing down energy prices, the most powerful influence on inflation. A Biden victory would be seen as more of the same current policies, although they would probably not be encouraging oil production as much once the election is over. Thus, we think a Biden victory would be a push toward higher energy prices and higher inflation, and the financial markets would price that in.

Confidence – Since the inflationary outcome is so dependent on war conclusions and letting up pressure on energy prices dependent on the Presidential election outcome, our confidence that inflation builds slightly during 2024 in fairly certain, and some of the forces of inflation will increase or decrease depending on the election results.

The Managers of Kanos Capital Management

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