March 2009 Investor Letter

First Quarter Market Conditions

I think the best way to characterize the first quarter of 2009 is to quote Charles Dickens from his opening paragraph in A Tale of Two Cities:

> "It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way..."

We truly live in extraordinary times: the US stock markets, as represented by the Standard & Poors 500 index registered its worst January performance in history. February's performance, while not historically bad, saw the S&P 500 have the worst performance since the 1930s. March's S&P 500 performance, while starting out very poorly, registered the fastest climb in the index since 1938, rising more than 25% from March 9 – March 29.

Most notably during the quarter, financial company stocks (both banks and non-banks) weakened considerably as their more of their loan problems emerged. Doubts that the US Government had plans or the human "horsepower" to help with these problems contributed to the stocks' fall, as did the threat of more activist government activities in financial companies' management and operations. Worsening economic conditions also showed up in rising numbers of unemployed US workers and people applying for unemployment benefits. The US dollar rose strongly during the quarter as financial market players converted securities and cash into US dollars to payback loans due to continued need to deleverage. European banks suffered far worse than their American counterparts, as European banks higher leverage caused more to be taken over by their national governments or caused surviving banks to shed assets from their balance sheets in order to bring down their leverage ratios and try to stabilize their equity bases. New US Treasury Secretary Timothy Geithner announced a US Government plan to try to shore up bank capital through the purchase of banks' "bad assets" in mid-February, but when the plans details were "not worked out yet" and the new Obama Administration did little but criticize corporate chieftains, the stock market broke to new thirteen-year lows

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by early March. The extreme pessimism, coupled with the seeming "exhaustion" of sellers, then led to the epic rally which lasted much of March. Financial stocks led the way, in some cases gaining more than 200% from their extreme lows, as financial market players saw economic indicators start to show some stabilization. Market advances were strongly supported by a lot of short-covering (people buying back shares that they had earlier sold short), after so many market players had become pessimistic, and short positions had grown to a very high level compared to typical trading volumes.

However, the single most important event of the quarter occurred on March 18th (in our minds!). The US Federal Reserve announced that afternoon the results from its bi-monthly Federal Open Market Committee meeting (which is the group within the Fed that sets monetary policy), and the agreements reached were historic: Ben Bernanke and the Fed announced that they would buy long-term Treasury bonds in the large amount of $300 billion (over the next six months, and additionally would buy $750 billion of mortgage-backed securities and up to $200 billion of Fannie Mae and Freddie Mac debt. This unveiled the actions that Bernanke had referenced in his historic 2002 speech (see last quarter's commentary) in which the Fed said it would buy bonds directly as part of their "quantitative easing" campaign – "monetizing the debt" or creating new dollars (from 'thin air') to buy US Government debt to drive down interest rates and allow holders of mortgage-backed securities (especially Fannie and Freddie) to "reload" their ability to fund mortgages through the Fed buying large quantities of them.

The Fed's quantitative easing announcement did a few things: gold rallied $50/oz in the span of about 15 minutes, 10- and 30-year bonds rallied the most since the 1987 crash (almost 50 basis points for the 10-year, an unbelievable move, especially in a 15-minute span), the US dollar index plunged, and most perversely, the US stock market jumped on this news.

The market continued its rally until late March, when the averages backed off due to profit taking and end-of-quarter "book squaring".

Precious Metals

In spite of the abovementioned strength in the US dollar, gold rose almost 5% during the first quarter of 2008, while many gold mining stocks performed even better. We concentrated our positions in larger precious metals stocks with known mineralizations and more predictable growth profiles, since more speculative issues still could have funding problems in the future as exploration and development companies look to start development of new gold and silver finds. Silver performed even better than gold during the quarter, rising approximately 11%, although it suffered more in last fall's downturn. Silver mining stocks did not fare nearly as well as the metal and the exchange traded fund (ETF) that tracks it, the iShares Silver Trust (ticker: SLV). However, our precious metals positions led our outperformance, as investors flocked to gold and silver as safe

havens/stores of values, and mining companies' prospects improved with higher metals prices coupled with lower energy and materials mining costs.

Energy

Crude oil prices gyrated wildly during the first quarter, with "prompt" crude (for immediate delivery, as represented by the nearby futures contract price) dropping as low as $33.60/barrel, but recovering in February and March to post a gain of over 11% for the quarter. Gasoline prices rose over 20%, as gasoline usage recovered from its extreme lows during the winter and stockpiles dropped for a number of weeks during the late winter period. Natural gas, however, dropped around 30% as ample supplies more than sated much reduced demand as the recession took hold of American industry during the quarter.

Commentary

"Thrilla in Virginia: Is This the Bottom or Is There More Work To Do?" (and Has Government Intervention Finally Gone Too Far?)

We spent a long time trying to frame our commentary for this quarter, because there are so many important elements that will impact the future of the world's markets and economies which occurred during this quarter.

But the big debate is: has the US stock market (and thus, much of the world's stock markets) hit bottom? Or is this a bear market rally, because the markets "have more work to do [on the downside]" because of the overhang of worldwide debt and still slowing economies? And has the US Government (in concert with many other world governments and the US Federal Reserve and other central banks) finally "arrested" the economic downturn through incentives, stimulus and easy money [low interest rates]? This is the 'Thrilla in Virginia', akin to a "Fight of the Century" heavyweight bout, pitting the ailing market economy in one corner vs. the power and resources of the US Government and Federal Reserve in the other corner.

Let's review the attributes of each fighter, starting with the fighter in the Blue Trunks: our first fighter is the optimistic camp, which combines the views of stock market bulls and the US Government/Federal Reserve, claiming that government influence is working, that we have reached a stock market bottom, and that the economy will bottom and then turn up in late 2009 / early 2010. The points in favor of this view are as follows:

1) The US stock markets bottomed out in two phases: first, last October 10th when more than 92% of the stocks on the New York Stock Exchange touched yearly lows and second, March 9th, when the major indices, led by the plunge in financial stocks, hit levels not seen in more than a decade. The string of days in February and March 2009 in which the markets were down 13 of 16 days represented capitulation, and the market now has fully discounted this deep recession.

2) Government programs to stabilize the financial system have averted a financial meltdown which could have led to a depressionary economic crash. In providing bank capital (through the "TARP" program), raising deposit guarantees at banks, guaranteeing money market funds, and various other programs, the financial system has been strengthened to the point that it survived and will start functioning more normally as the recessionary economy bottoms and starts to recover.

3) Low interest rates delivered by the Federal Reserve have helped bring down the cost of financing while not stoking any inflation (due to the deflationary forces of falling asset prices and consumer durables prices), meaning the economy can recover faster through cheap financing and less onerous interest costs.

4) While the economy is still bottoming out, the stimulus has worked; when economies stop growing or start to shrink, it is the job of the government to "take up the slack" and spend when the private sector is not increasing spending. Starting with the initial stimulus from April 2008, and coupled with the February 2009 massive version, the US Government will "seed" the economy and make sure that there is revenue for companies to help them underpin their operations and stay viable financially until the economic recovery takes hold.

5) Averting the economic catastrophe will allow the new Obama regime to be able to implement some of the classic Democratic Party "planks": an energy policy built on future inventions to replace fossil fuels with biofuels and alternative energy technologies, an environmental policy which emphasizes fighting global warming and reducing access to land for resource recovery or industrial applications, expanding governmental control of health care, and "fairer tax burdens" – raising taxes on the rich to supplement the poor and middle classes.

6) Housing has nearly reached bottom, as housing starts reach levels not seen in more than a decade, and housing permits (a precursor to housing starts) and mortgage applications are starting to pick up, signaling that consumers may be starting to clear the inventory of houses in the US.

7) Market pundits point to a number of occurrences in the financial markets to indicate that we have seen a bottom in financial markets and that the recession should end in the next few months:

a) As mentioned above, new lows and other internal market technical indicators in the market bottomed in October 2008 and many others in March 2009, and this is a classic bottoming pattern (similar to when stock prices bottomed in November 2002 and finally in 2003 at the end of the last recession). Buying support from large institutions has started to increase, and selling pressure from large stock market players appears to be dropping. In addition, the VIX index, a measure of volatility in the stock market, has receded from its "spike" readings above 50 (and as high as the 90s last October) to around the 40 level and below. Volatility usually drops when the market expects less uncertainty and the expectation of large drops in the market recedes.

b) Many commodity prices have risen strongly from their late 2008/early 2009 bottoms, indicating that demand from still growing areas of the world (few besides China and other pockets in East Asia). Crude oil traded as low as $33/bbl in January, but has now recovered to $50/bbl. Copper, often called "Dr. Copper" because its price moves "as if it had a doctorate in economics," traded in the $1.20s/lb in December 2008 but has recently traded substantially over $2.00/lb.

c) A number of economists and market commentators now see the economy slowing its descent (i.e. it is not getting worse as quickly), which they believe indicates that the bottom to the economy is near. Even before the economy has bottomed, the financial markets will show healthy gains as the market anticipates the economic recovery.

This is obviously the more bullish case, because it shows that there is "light at the end of the tunnel" [not a train ☺]. It shows that with governmental help and some elapsed time, the economy is going to recover, although this will end up being the longest post-World War II recession. However, that is only one side of the story…………

A number of market watchers and pundits are not sure we have reached a bottom in the stock market and don't believe the recession is about to end. Before tackling the other side of the issues discussed above, we would like to address something that has been bothering us about the current "recession" – to us, a recession happens after the Federal Reserve raises interest rates to moderate quickening economic growth and inflation. When the recession takes hold as the economy slows, the Fed lowers interest rates to re-ignite growth. That did not occur this time – from our perspective, the Fed never really raised rates very high after the 2001-2002 recession (from a historically low 1% during

2003 to a still-low 5.25% by 2006), and when the economy slowed and then "fell off a cliff" in 2007-2008, the Fed lowered interest rates effectively to 0% and implemented huge amounts of bank lending programs, culminating in quantitative easing. This sounds like something much different to me, and Ray Dalio, founder and chief investment officer at hedge fund operator Bridgewater Associates (recently interviewed in Barrons financial magazine), gave a very good synopsis of the difference that I would like to reproduce here:

> "Contrary to popular thinking, a deleveraging/depression is not simply a severe form of recession – it is an entirely different process. More specifically:
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> - A recession is a contraction in real GDP brought on by tight central bank policy (usually to fight inflation), that ends [soon after] the central bank eases. It is relatively well-managed via interest rate changes. Lower interest rates stimulate demand by 1) reducing debt costs, 2) lowering monthly payments (de-facto costs) of items bought on credit and 3) raising the prices of income-producing assets like stocks, bonds, and real estate through the present value effect of discounting their expected cash flows at the [now prevailing] lower interest rates.
> - A depression is a self-reinforcing economic contraction brought on by debt and debt service payments being too high relative to cash flows to service them, in which monetary policy is ineffective.

Unfortunately, the second sounds much closer to what we have faced so far. However, we want to make sure we are not overreacting, so we looked further. The Economist, in an article dated December 30, 2008 states:

> "A search on the internet suggests two principal criteria for distinguishing a depression from a recession: a decline in real GDP that exceeds 10%, or one that lasts more than three years."

Using this criterion it appears that what might have started as a recession changed into a much more serious financial matter, and we as a country and world must try to navigate and survive what looks more like a mild depression. We don't think it will be like the Great Depression, because that financial collapse originally was a financial downturn/recession, but it was made worse by a collapse in world trade (due to protectionism) and a shrinking in money supply (due to being on the gold standard and not being able to expand money supply) which amplified the deflationary effects of the collapse of over-levered banks and finance companies and led to a collapse in economic activity. The Fed's (and other world central banks') efforts, capped with the 2009 campaign of quantitative easing, should keep money supply from being the problem it was in the 1930s, and the economic cooperation and planning among the US, European and Asian governments and central banks seems to indicate that protectionism won't be the trigger that torpedoes world trade this time around. So…….

The other fighter is the capitalist-based market economy of the United States and most of the rest of the world, wearing the Red Trunks. The Red fighter enters the ring already battered and bruised, a little unsure of himself, and a lot of his body hurts. He is not sure what is wrong with him, but he knows that he will have to fight hard to survive. He is not sure that the worst has already occurred, and is unsure about how long his travails will last. The following are counter-points to those listed above for the Blue Fighter:

1) The stock market, while hitting an "interim bottom" in March 2009, is probably going to go lower at some point in the future. The day the market hit its recent bottom, March 9th, the S&P traded closed at 670 with forecast 2009 S&P 500 earnings implying a Price/Earnings ratio on that day of 14x. S&P 500 statistics at March 31st, with the S&P 500 at 797, implied a P/E over 52x (with all write-offs included) and a dividend yield around 3%. While these statistics show lower valuations than seen recently, generally at bear market bottoms, stocks sell for single-digit P/E ratios (6-8x) and dividend yields exceed 5% (as happened in 1957 and in 1974). Thus, it appears that the "slow motion crash" we observed in the stock market over the past few months did not send stocks <u>as far down as we have seen in past downturns</u> to reach compelling values that are often seen at bear market bottoms. A number of people in the investment business and in the financial press (especially on financial TV networks) have called early March the definitive bottom. Usually at market bottoms, people are wary, disbelieving of any advance, and unwilling to call an uptick as having marked the bottom. The bottom is usually determined in arrears when the market never breaks to even lower prices.

2) Governmental programs, while saving the banking system from panic, are being used to maintain the former status quo at a time when the financial system needs to be transformed through restructuring and deleveraging. Generally when banks are having systematic problems, the government sets up an FDIC/RTC entity that takes over insolvent banks, cleans them of their toxic loans, sells the resulting healthy bank out into the marketplace, and tries to recover collateral or payments from the bad loans over time. During this instance, the government has left management in place, lent large sums of taxpayer money to the financial institutions, allowed bondholders to maintain their senior call on assets, and not even wiped out the common stockholders. This strategy is piecemeal and incremental, and may draw out the problems over a much longer period of time, threatening to make a number of large US banks "zombie banks" (named for Japanese banks in the 1990s which had so many bad loans that they couldn't make new loans, but the government allowed them to carry the bad loans as if they were current, i.e. they were alive but couldn't do any activity). Thus, it is unclear, absent government guarantees and subsidies, how well the economy would work right now,

which means we must be concerned about how we "recover" and how / how fast the governmental support programs and payments are withdrawn.

3) Low interest rates and the lack of enforcement of regulations (more important in our opinion than just low rates) caused the housing bubble and the 1980s/ 1990s/2000s debt build-up when Alan Greenspan was chairman of the Fed. Greenspan, and later his successor Ben Bernanke, pursued a policy in which the Fed eased interest rates, sometimes severely, to overcome any financial crisis whether it was justified or could have been omitted. This is an important point, because just a few months after Greenspan took office, the Crash of 1987 occurred; during the crisis, Greenspan let it be known that liquidity would be available to all commercial banks to keep them liquid, and this contributed to averting the crisis. He then resorted to the same "medicine" during the 1990-1991 recession (justified), 1997-1998 Asian/Russian financial crisis (questionable), 1998-1999 Y2K scare (unjustified – helped set off the dot.com bubble), 2001-2003 mild recession (unjustified to take rates down to 1% and keep them there for months). These low rates were coupled with a number of regulatory "easings" and lapses that led to overleveraging in the US (and world) consumer, business and especially financial balance sheets. Simon Johnson, in his May 2009 article "The Quiet Coup" in The Atlantic magazine, summarized them best [with my comments in brackets at the end of some of the bullet points]:

> "…in just the past decade, a river of deregulatory policies that is, in hindsight, astonishing:
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> - Insistence of free movement of capital across borders;
> - The repeal of Depression-era regulations separating commercial and investment banking [the Glass-Steagall Act, deconstructed with the merger of Smith Barney and Citibank in 1999];
> - A congressional ban of the regulation of credit-default swaps [after Brooksley Born, the head of the Commodity Futures Trading Commission under Clinton, had attempted to regulate these derivatives like futures in 1998];
> - Major increases in the amount of leverage allow[ed] to investment banks [until 2004 broker-dealers leverage could not exceed 12:1; the SEC changed the rule for 5 investment banks due to their "superior risk systems" to leverage up to 30:1 or 40:1 – Bear Stearns, Lehman Brothers, Merrill Lynch, Morgan Stanley and Goldman Sachs. The first three, of course, no longer exist];
> - A light (dare I say *invisible?*) hand at the Securities and Exchange Commission in its regulatory enforcement;
> - An international agreement to allow banks to measure their own riskiness;

- And an intentional failure to update regulations so as to keep up with the tremendous pace of financial innovation.

The Fed has said it will continue to provide reserves for financial institutions and buy Treasuries, mortgages, agency debt and eventually corporate debt as it tries to make sure that dollars are available in the US and abroad in larger and larger amounts – obviously an inflationary influence in a world threatened with further asset deflation magnified by a worldwide heavy debt burden. At some point (and we believe relatively soon), this will become an inflationary problem. The recent meeting of the G20 further fueled the inflationary influences by pledging to make available to the International Monetary Fund an additional $750 billion to be lent to other countries affected by the financial crisis.

A by-product of this inflation-inducing strategy will be a weakening of the US dollar. After US dollar-denominated debts are restructured around the world, the dollar should becomes less desirable for foreigners to hold because of ultra-low US interest rates, the growing numbers of dollars in circulation, the virtually out-of-control spending of dollars by the US Government, and the realization that other currencies or gold belong in other countries' monetary reserves.

4) The stimulus plans are almost certainly failures for two reasons: 1) the concept of stimulus is thought to be a way for government to inject productive activity into the economy which will provide people and companies activity during languid economic times, however, the government has done a poor job. The Bush stimulus handed people under a certain income level a check of a few hundred dollars; this was supposed to be spent, but a number of people either saved the money or paid off credit (used to pay for previous purchases), rendering much of the stimulus "unproductive". Obama's version of stimulus will be government controlled, but a large amount of the nearly $800 billion will be given to the states, almost all of which will use some of the money to pay off old debts that are causing large deficits in their 2008/2009 budgets! (sound familiar?) The other reason is: 2) in 2010-2011 when "shovel-ready" projects dominate the program, much of the urgency for stimulus may have already passed. Meanwhile, the costs of the stimulus are never recouped during better times – it is rolled into the national debt, making it all the more unbelievably big. Stimulus, while a noble idea, generally is trying to get people to spend more at a time when they need to "heal their finances" and build back their balance sheets by getting rid of leverage – encouraged spending doesn't help when one is in serious financial constraints.

Even having said the stimulus is not very productive, we believe that governments will end up providing further stimulus packages at least one

more time as the debt-burdened economies recover very slowly. And interestingly, there are some countries which appear to be administering economic "medicine" in more effective ways than either the United States or Europe: Communist China has reduced reserve requirements in banks a number of times in the past few months (after raising them more than a dozen times in the 2005-2008 timeframe) and has lowered taxes (including going to a 0% capital gains tax) to boost economic activity. China's large (compared to GDP) stimulus package is more geared toward infrastructure projects and loans to small businesses to revive economic growth. Russia has also lowered income taxes, and is contemplating lowering taxes on its energy industry, where most of Russia's revenue is sourced. Canada, after raising taxes on its energy industry twice in the past few years, has lowered taxes / royalty rates, thus applying stimulative moves in the industry most important to Canada's economy. These are the kind of moves that make "stimulus" a workable form of assistance; we still believe the US version is nowhere close to as effective as these countries' efforts.

5) Obama's energy policy is big on reliance on biofuels and taxation / regulation to force the US economy off fossil fuels. Taxation through either a carbon tax or a cap-and-trade system for greenhouse gas emissions will be a huge (and regressive tax, affecting rich and poor equally) tax burden, just when the US will be (hopefully) emerging from its depression. These taxes will saddle US industry with huge new tax expenses that will make US products much less cost-competitive worldwide [assuming a number of other countries do not enact similar cost carbon tax structures on their depressed industries]. In addition, since energy prices have dropped back from last summer's highs, Congress and the Obama Administration, along with some states, are looking to re-institute bans on offshore drilling and drilling in "sensitive" areas, to be defined by the Democratically-controlled Congress. Finally, new government regulations and restrictions on emissions will make the cost of energy and energy costs to US industry even higher than just the tax burden. These measures will raise the cost of energy immensely, allowing biofuels and renewables to start to become competitive by driving up the cost of cheaper fuels by government action. Some say the "match" that set off this worldwide economic downturn was the high energy prices of late 2007/first half of 2008. If that is the case, these new energy policies, if implemented quickly, will retard economic recovery for years, not months. More about oil and gas will be covered below under "Thoughts for the Future".

6) Housing has still not shown that any sustainable strength has returned to the market. Housing inventories stand near all-time highs, at almost 12 months of inventory for sale. Nearly 45% of sales in the first quarter were sales connected with some kind of financial distress (foreclosures, etc.), not the stuff of recoveries. The affordability index, which we talked about in our

June 2008 newsletter, has returned to a more normalized level, but as incomes drop during this depression, the affordability factor will further push down housing prices. In addition, many believe there is a "shadow inventory" of houses that will come onto the market once prices start rebounding, as those who wanted to sell but did not want to compete with foreclosures, try to get "better prices" for their homes. Housing is still falling in price, and until a few months of price stability is observable, the housing industry is vulnerable.

7) A number of market occurrences point toward the market going through a bear market rally, rather than the start of a new bull market. If these technical factors prove to be the better indicators, the market will break to new lows before a real bottom is reached.

I have included a complicated weekly S&P 500 technical chart study (on the following page) which shows (with light green overlays) a number of technical factors that do not favor this being a new bull market. The chart is complicated, but it is a typical chart which market "technicians" use to try to gauge where the market is headed next by analyzing what has happened in the past. This chart is set up in what are called Japanese candlesticks which chart the level of the S&P 500 index levels using red and white bars in the middle of the chart. These red and white bars indicate the high price, low price, opening price and closing price of the index during a week (each bar represents one week of price movement). A weekly chart with 10-week (or 40-day) and 40-week (200-day) moving averages is a standard chart on which to look at technical market indicators.

a) One of investing's most enduring "rules of thumb" is that <u>price follows volume</u> (or the converse, <u>if the volume drops on a move, the move will probably reverse itself</u>). On the chart above, volume is illustrated by the red and grey bars that are illustrated in the middle of the chart – the rise from the March 9th depths has been on lower volume than the volume that occurred during the drop (see the green line labeled "1");

b) The S&P 500's advance hasn't retraced back to its 200-day moving average (the falling red line in the middle of the chart; it is labeled on the

left as MA (40) or the 40-week moving average). The advance "should be" over and above this average line if this advance has long-term staying power (see the green circle labeled "2" around the red-line indicating the 40-week/200-day moving average);

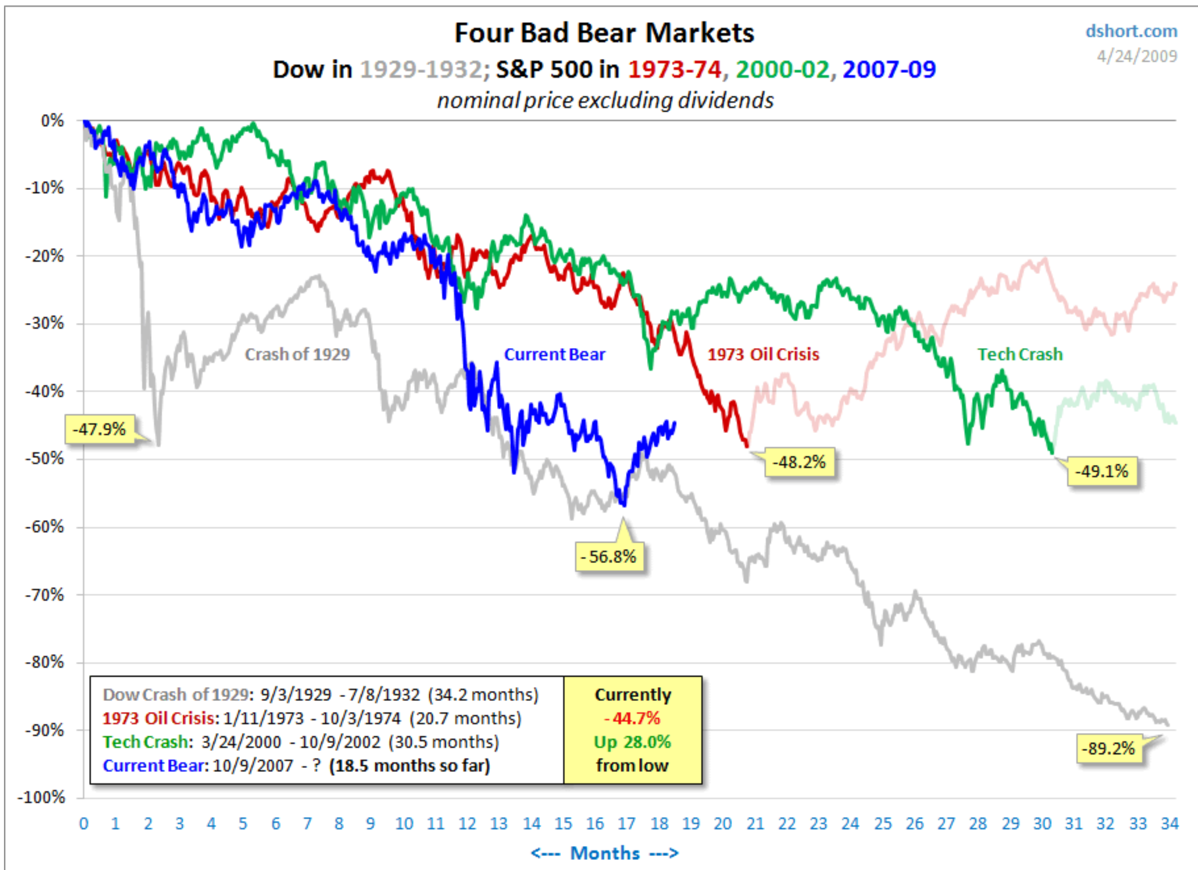
c) The MACD (moving average convergence divergence) technical indicator (the chart that is near the bottom, with blue bar chart lines) has basically flattened out, meaning the advance appears to be "losing steam" (see the green circle labeled "3");

d) The full stochastic technical indicator (the bottom chart indicated as "Full STO") shows that the advance started from an extremely oversold level (probably about 15 on a 100 point scale – see green circle labeled "4"); when markets are that oversold, they almost always have a strong reflex rally;

e) The full stochastic technical indicator now shows a reading of almost 80, a point where markets are considered overbought (see green circle labeled "5"), which might show that the rally may have played out; and

f) The stocks which rallied the most were two groups: 1) those with the largest short interest, meaning at least part of this rally was shorts covering their positions through buying, and 2) those that were priced less than $10/share, which means that they have a lot of leverage and many were "fallen angels" which had fallen so far that their low price allowed traders to buy larger quantities of stock (examples: Citigroup [rallied from ~$0.90/share to $4+/share], Bank of America [rallied from $3+/share to $11+/share] and General Electric [rallied from ~$6/share to ~$11/share], to name just a few). Rallies of oversold and over-shorted shares at low prices should generate <u>higher volumes</u> of trading, not lower volumes. This appears to indicate that the majority of the volume is confined to these "lower quality" stocks, which are almost never "the leaders" in a new sustained bull-market advance. Once short positions are covered, buying impetus for stocks usually drops, and any further advance must be dependent on incremental buyers alone.

For all these reasons, it appears to us at Kanos that the world's stock markets and economies are in for more tough sledding. As an illustration of this, we found a graph (see below) that compares this downturn to earlier ones; in our minds you can see how it tracked recent economic downturns, then got much worse in September/ October 2008 (large drop) and starts tracking along the downtrend of the early 1930s Great Depression market.



Thoughts for the Future

As you probably know, we have been inflationists for the last few years as easy credit, a depreciating dollar, worsening US economic conditions, and low supply/higher demand fundamentals for commodities led to higher prices for inflation-sensitive investments such as commodities, commodity stocks, and service company equities.

The mild depression we are experiencing now has introduced quite a bit of confusion into the analysis, as demand fell off, and companies/countries fiscal situation were muddied. While demand makes the big difference in the short-term, we still believe that supply is as big a factor over the long-term. The boom in commodities, including energy, metals and soft commodities, starting in the early 2000s, led to renewed interest in supply sources, namely wells and mines. However, the time frame for developing those supply sources has in the past few years been extended due to the "harder-to-extract" nature and more remote locations of large scale concentrations, which also allows more time for projects to be put on hold or cancelled, depending on ensuing economic conditions (like now). This is a long-winded way of saying that the projects take a long time, and many

are now being put on hold or postponed indefinitely due to the lower pricing regimes and the uncertainty associated with financing and industrial recovery.

As a result, we believe that the supply response to lower energy and metal commodity prices is lower output in the medium-term, and since we were only in "mid-cycle" as far as new mines and large petroleum deposits, we think that a number of projects expected to come on-line in the next few years will not come on for many more years. Thus, we are still bullish on precious metals and energy as will be detailed below.

Precious Metals

In spite of a stronger dollar during the quarter, gold and silver both rose in price during the first quarter (as mentioned above). However, both were significantly higher during the stock market plunge of mid-February, and gold sold off when it could not better its $1,000+/oz all-time high reached last March (during the Bear Stearns crisis) and nearly reached again in June 2008. Many traders interpreted this as gold "having a ceiling" at around $1,000/oz, and gold was sold down from its high. Silver basically tracked this same trajectory. In March, "quantitative easing" was announced by the Fed during the quarter, essentially codifying what the Fed had indicated would be its policy, but stepping up the efforts, promising to (create and) spend $1.25 trillion in the next six months on buying government, mortgage and agency bonds (and possibly more after that) in order to hold down interest rates and further liquefy the US economy. This was very good news for precious metals, and the metals rallied on the news.

However, there have been some headwinds that gold (especially) and to a lesser extent silver have had to overcome. Historically high prices (pre-2008, gold's all-time high was ~$850 in 1980) have caused a number of traditional buyers of gold for jewelry to cut back (or in some cases virtually eliminate) their gold buying. India is traditionally the largest buyer of gold, but they have cut back their recent purchases to a rate of 10-30% of their peak buying rate, since they had become used to much lower prices in the recent past. At the same time, US (and other developed country) citizens have been sellers of gold scrap, taking advantage of historically high prices. Finally, the International Monetary Fund, which received many years ago gold from the countries which created it, recently announced that it would like to sell up to 400 tons of gold to have cash to lend to "in-need" countries. This cast a pall over the market, because of the size of the possible sale. We aren't too concerned about the IMF sale for three reasons: 1) the sale must be approved by the Congress of the US, which has in the past seemed to be reluctant to let the IMF sell gold, and it has a lot on its "plate" right now around domestic policy, 2) the sale, if it goes through, will probably be in bulk to countries who have less gold as reserves than they would like (including both China and Russia, which have both said they would like to increase their gold reserves), meaning that the sale would probably have little effect on the gold futures market, and 3) IMF sales of gold have been hanging over the market for a couple of years now, so the actual sale would remove this "price threat", meaning gold could move up on the news. All these factors have been pulling at

the gold price: threatened IMF sales, small owner scrap sales, and limited/eliminated purchases by jewelry buyers, and yet gold has stayed above $800/oz all year and has recently topped $900/oz again. We think that much of the bad news for gold is in the price, and bullish news (inflation indications, geopolitical problems, etc.) will tend to propel the price past $1,000/oz. Silver, which is still more industrial than gold, suffered larger losses from the peak than gold due to its more industrial demand profile, but has since rebounded from the extreme lows set last October/November. It seems that the industrial weakness of silver has been built into the price, and now silver has resumed a bull trend.

Finally, I saw a recent study that compared the Dow Jones Industrial Average to the price of gold, and where that ratio was at various "significant turning points" in American financial history. Look at the interesting data points:

Date	Dow / 1oz. of gold	Significance of date
Aug 7, 1896	1:1	Origination of the DJIA by Dow
Aug 30, 1929	18:1	Peak of the 1920s bull market
Aug 8, 1932	2:1	Trough of the Great Depression stock market
Nov 26, 1966	28:1	Peak of 1960s bull market
Jan 21, 1980	1:1	US in recession after stagflation of 1970s; gold peaks at 850
Jul 16, 1999	44:1	Nasdaq bubble growing larger with cheap fed funds; gold near bottom of 20-yr bear market
Mar 31, 2009	8.4:1	Current ratio

So the question is this – if we approach the trough levels of 1932 and 1980, the Dow:gold ratio could be ~2:1 or possibly lower. This argues powerfully for a long gold, short market position. However, we believe inflation may also affect stocks positively (at least at times), so we are going to be more conservative and not short stock indices against gold. Instead, we will hold gold and/or gold stocks and have a short market position at times of financial stress. If gold does approach a 2:1 ratio, we believe that gold will have significant appreciation to reach the 2:1 level (8000 Dow, 4000 gold?).

Energy

Oil and gas prices have diverged recently. While economic activity continues to be weak, oil prices have recovered from the low $30s/bbl to reach the $50/bbl area. Oil demand fell off strongly with high prices last summer/fall, but oil and oil products demand has fallen off less than US economic activity. Natural gas prices, in spite of one of the colder winters in recent memory (Chicago had the 10th coldest winter in history this past year), fell as industrial activity, led by automobile manufacturing and auto parts

companies, fell to multi-decade lows. The auto and steel industries use huge amounts of natural gas, and their low factory utilization rates led to reduced overall demand, which led to lower storage withdrawals, even during a cold winter in the Midwest and Eastern US, leading to lower prices.

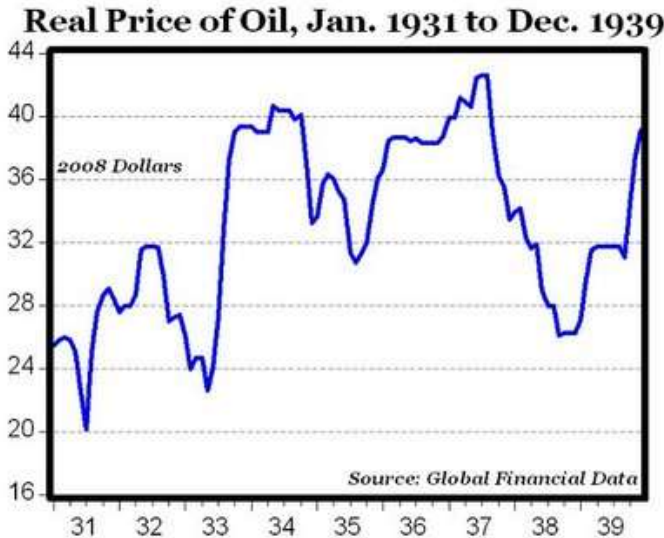
Low oil prices have led to reduced supplies, and we believe that further economic weakness and continued low prices will lead to underinvestment, not only in new projects but also maintaining current production ("maintenance capital expenditures" which include reworking older wells, replacing rusted equipment, inspecting pipelines, etc.), especially in national oil companies expected to dividend revenues to governments, like Pemex in Mexico, PDVSA in Venezuela, NIOC in Iran, and even Gazprom/Rosneft in Russia (through taxation). Combined with natural depletion and cancelled new projects (no oil sands projects will be built in Canada now for the next few years, for example), we believe deliverability will drop off dramatically, eroding what most consider the world's "reserve deliverability margin [mostly in Saudi Arabia] of approximately 4 million barrels.

A prime example of the above points is that Mexican oil output in the first quarter fell 7.8% compared to 1Q2008 showing that Mexico's supergiant field, Cantarell, is continuing to have big depletion amounts – 34% (!) less volume produced than last year, falling from 1.2 million bbls/day to 787,000 bbls/day. More disturbing for the US is that this reduction in output led to a much larger drop in exports – 14.7% less than 1Q2008, showing the problems with burgeoning domestic demand and falling absolute export volumes in Mexico. One has to remember what the International Energy Agency reported in its annual report this winter: 14% of the entire world's oil comes from the ten largest fields, and 4.5% of the world's oil comes from the next ten. So 18.5% of the world's oil is from the twenty largest fields, and these 20 fields average **fifty-nine years of age** and **16 of the 20 are past their peak output rates!** These are worrisome statistics, because Cantarell was discovered in 1976 (thus it is only 33 years old), and output has dropped from its peak in 2004 of 2.14 million bbls/day to today's 787,000 bbls/day, a drop of 63% in less than 5 years!). We believe this illustrates how a poorly maintained field can fall significantly in output when not operated well and underspending retards maintenance, causing more problems.

Natural gas is a whole different animal, since it has traditionally been a mostly domestic market, but is now a worldwide market with the expansion of the world's liquefied natural gas (LNG) sector. LNG liquefaction projects, where "stranded" natural gas is converted to liquid to be loaded on tankers and sent to gasification terminals, had reached a point last year that a huge amount of new LNG supplies are scheduled to come online in the next few months, and much of that gas is expected to end up in the US. Typically, LNG heads to China, Japan, Korea and southern Europe where industry and heating load relied on LNG for their energy supplies. However, with the collapse of exports (Japanese exports were down 35% during January, for example), many of these countries don't need contracted LNG supplies, and these supplies are expected to be reach the US,

displacing more expensive "shale play" gas output which had contributed to the "gas glut" which drove down prices this winter. We believe that most of this supply/demand equation is built into the current price of natural gas, but if the economy continues to bump along as we expect, we believe natural gas will see an up-and-down market, trading down into the $2+/Mcf range and up into the $4+/Mcf range. If the world economic situation recovers in 2009 (like Ben Bernanke has predicted – we think he is being pretty optimistic), then gas prices in the US could rebound because the threat of LNG supplies will fall.

Finally, we thought it was interesting when we saw that oil prices during the Great Depression in the 1930s were up strongly, more than doubling from peak to trough (see graph below). We find this interesting because demand was growing (due to the expanded use of cars and trucks) but oil was far easier to find. The giant East Texas oil field was found and developed quickly starting in 1937 – you can see the effect, with oil dropping from $42/bbl to $25/bbl. One would have thought that the effects of deflation would have kept oil prices, especially with large new discoveries occurring, low and falling, but it was not the case. Today's continuing industrialization of East Asia and India, coupled with falling prices of cars, should lead to increased usage of transportation fuels, leading to more demand for oil supplies. In fact, Platt's reported that China's March usage of crude oil in March 2009 was down only 0.25% from usage totals in March 2008, even though economic activity slowed from over 10% GDP growth in early 2008 to ~6% GDP growth today. Even US gasoline usage as reported by the US Energy Information Administration is down only 0.1% year-on-year (on four-week average basis through 106 days of 2009), although distillates usage (diesel and heating oil) is down 6.2% y-o-y, much more in line with economic activity.



General Stock Market

We believe that the stock market will continue to show periods of strength (like we have seen lately) and also periods of weakness, leading to an oscillation of the averages. We expect uneven economic growth, lack of pricing power, higher raw material costs, and a lull in productivity and innovation to lead to poor profit growth in many US companies, meaning P/E ratios may fall. In this environment, we want to continue to hold cash and own low P/E, solid balance sheet companies with a possibility of large upside, like commodity producers and service companies in which we are invested. We continue to believe that this aggressive defensive stance is preferable to trusting that an upturn has occurred when so many suspect data points are still in existence in the world's market and economies.

When we believe that the still-bad fundamentals of the US economy start to get resolved, and blue-chip US stocks trade at levels in the 6-8 P/E ratio range and yields exceeding 5%, we will be ready to invest in a diverse portfolio of US stocks. We believe it could happen sooner rather than later, because we currently think that we are only in a mild depression. If politicians worldwide start to fall back on protectionist tendencies, we can see the depression getting worse. However, if they maintain their current stance of working together, continuing to address free trade disagreements, and invest in real productivity-enhancing investments domestically and internationally, we see the growing economies of the developing world, led by the Brazil, India and China, leading the worldwide recovery.

We would like to once again reiterate our thanks for your trust in letting Kanos manage your precious capital. We take the responsibility of investing your money seriously, emphasizing ways to preserve capital while trying to prudently grow it at opportune moments. We welcome questions and comments, so please don't hesitate to call or e-mail with questions or comments.

The Managers of Kanos Capital Management

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