March 2011 Investor Letter

First Quarter Market Conditions

January showed a slow, steady upward grind in most equity indices as market participants felt that developed countries' economies were continuing to strengthen. However, some of the "leadership" of the last year experienced strong downward moves while other companies continued to power upward in price so that equity indices rose. Most notably, precious metals had a poor month, as traders rotated their investment to new themes and momentum investors sold their positions in droves. While gold was only down 7% during the month, some "high beta" precious metals stocks were down 15%. On the other hand, energy surged as oil prices (as measured by the more global Brent crude pricing) rose to around $100/bbl, pushing oil and oil service stocks up strongly. Industrial, technology and base metal materials companies also did well as investors made more investments in industries most impacted by a growing world economy. Interestingly, emerging markets' stock markets, the stars of 2010, were very weak in January, moving down strongly as traders looked for bargains in the developed world markets. The bond market held relatively steady during the month, although the dollar weakened steadily. Soft (food) commodities, along with energy, rose the most in price in the commodity world as cold weather and continued bad news on crops led to higher wheat, corn, soybean and cotton prices.

February was a solid "up" month, with the general stock market, as represented by the S&P 500, up more than 3.5% - the best February performance in more than a decade. Resource stocks were the big winners during the month; metals stocks rebounded strongly from their miserable January performances, and energy stocks were strong on the back of skyrocketing crude oil prices. Food riots, which started in Algeria, quickly spread to Tunisia, Egypt, Libya and a number of Arab Mideast countries, toppling autocratic rulers in Tunisia and Egypt and interrupting crude oil flows due to fighting in Libya, Yemen and slightly in Oman. The US Treasury bond and the US dollar markets both had poor months as continued high fiscal budget deficits and the continuation of quantitative easing took its toll.

Interestingly, with the S&P 500 up almost 6% year-to-date through February, JPMorgan showed why its strategists thought the market would continue higher: underinvestment by "big money" portfolio managers. As of February 28th, a number of mutual fund managers were already severely underperforming their benchmarks as many market

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participants had anticipated a pullback after a strong 2010 market performance. More specifically, according to JPMorgan, 16% of all equity portfolio managers had underperformed their indices by at least 2.5% year-to-date, and 7% had underperformed by at least 5%, just through February. In addition, equity hedge fund beta, a measure of a fund's exposure to market movements, was just 0.14 at 2/28/2011 (1.00 represents a full market weighting) while mutual fund managers' beta was 0.94 (still low, since most mutual funds are expected to be fully invested at all times). Finally, JPMorgan thought equity levels indicated the market expected the S&P 500 to produce $88 in earnings for 2011, when most expect earnings to be closer to the $95-100 range, meaning they believe there is at least another 10% appreciation in the market for 2011. The juxtaposition of underinvested and highly-motivated portfolio managers and turmoil in oil/Mideast geopolitics led to higher volatility for the quarter and possibly longer, depending on how Mideast unrest is resolved (or is not resolved, potentially).

Markets went through a lot of volatility in March, most notably the earthquake/tsunami/ nuclear problems of Japan in mid-March and the escalation of combat in Libya, but the general stock market recovered to preserve a 6%+ gain for the first quarter. However, sector moves were wildly divergent. With crude oil rising over $100/barrel (and setting nearly 3 year highs at the end of March), energy stocks led the S&P higher. Industrials and healthcare also had very good performances during March and the first quarter, while laggards included financials, technology and consumer discretionary. Precious metals prices closed either at or near multi-year highs, although metals stocks reacted to high energy prices, rising less than the metals themselves. Emerging markets stocks did not recover their earlier drops, mostly because the problems of Japan were thought to impact emerging market economies in the short term. Bonds and the dollar also underperformed during March, as market players thought the Fed would continue its "easy money" QE2 policies to lessen the shocks to world economies caused by the Japanese problems and resulting economic slowdown.

Precious Metals

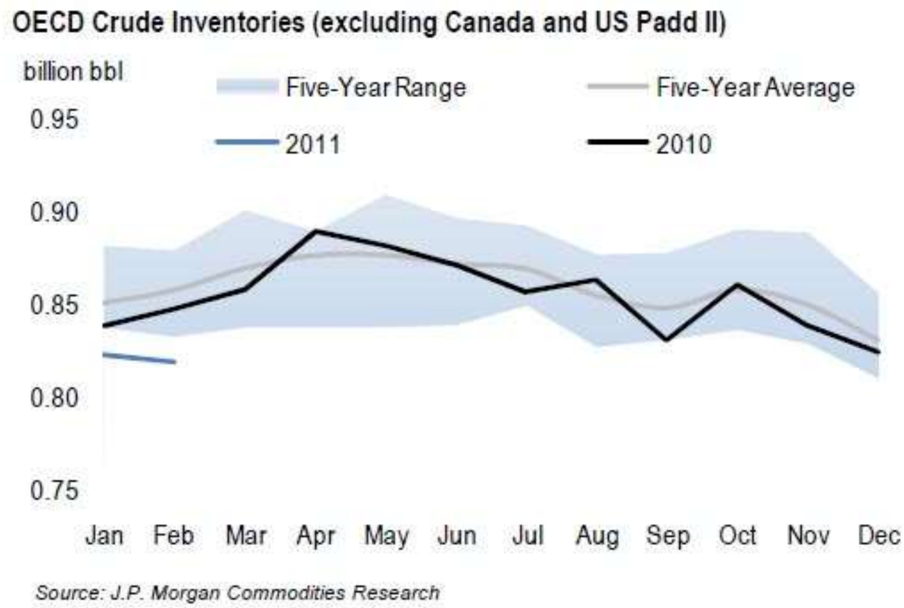
As mentioned above, precious metals lost their December momentum as market participants rolled out of 2010 winners and redeployed funds into different sectors. Precious metals saw corrections in January (gold down about 7%, silver down over 10%), while the precious metals equities were down even more – some high-growth companies were down almost 20%. As regime change came to North Africa and fighting erupted in Libya and Yemen, with unrest in Oman, Bahrain and other countries, precious metals came roaring back during February to close near all-time highs, while silver reached highs near $35/oz. In contrast, industrial metals, such as copper and palladium, rose during January and settled back during February, as world political unrest made traders less sure of continued strong economic growth with energy prices around $100/bbl of crude oil. March saw silver rise strongly, closing March around $37/oz as inflation fears combined with its industrial usage pushed prices to 30+ year highs. Gold did not appreciate during most of March, as technical traders sold it off thinking that it may have broken some technical levels; however, gold bucked these sentiments and rose at the end of March, closing near its all-time high above $1430/oz.

Energy

Crude oil continued gains from 2010, bouncing between the mid-$80s/low-$90s per barrel of West Texas Intermediate (WTI) during January. But during January, as unrest in North Africa started to spread across the region and into the Mideast, Brent-grade crude oil rose at a much faster rate, since it better represents the worldwide market than land-locked WTI which delivers at the central Oklahoma pipeline crossroads of Cushing but is difficult to export due to pipeline configuration (pipeline in the Midwest generally funnel crude oil production to Cushing where it is fed to Midwest refineries; however, crude supply is outstripping the throughput of US Midwest refineries, creating a glut. So far, no pipelines have been reversed to alleviate this glut).

Brent crude gained approximately 15% in January and another 10% in February, ending the month near $110/bbl as crude flows were interrupted from Libya and Mideast tensions which led to a large (estimated at ~$15/bbl) fear premium for Saudi unrest. With the civil unrest erupting in Arabian Peninsula nations of Bahrain, Oman, Syria, Jordan and to a very small extent Saudi Arabia, Brent crude finished March above $117/bbl (and WTI above $106/bbl) as Libyan fighting intensified (making Libyan light, sweet crude possibly interrupted for many months) and concerns about more fighting included Nigeria, which is starting presidential elections (Nigeria also produces the lightest sweetest crude in the world, most prized by refiners around the world). Saudi promises of more production to replace any interruptions would only be heavy, sulfur-laden crude, very much harder to refine than Libyan or Nigerian crudes.

While the US Midwest/Canada is well-supplied with crude oil (as shown by the abovementioned WTI discount to world crude prices as represented by Brent crude prices), the rest of the developed world's supplies are lower than in recent years as show by the graph below:



Natural gas, after reaching nearly $4.70/MMBtu twice during a cold January in the United States, peaked in late January and slid through most of February (although it did experience an end-of-month rally), ending the month near $4.00/MMBtu. In March, cold temperatures and falling storage volumes allowed prices to rally strongly, closing the quarter near $4.40/MMbtu, showing resilience that caught many market bears short.

Other Markets

As mentioned above, longer-term bond yields continued their rise as strong US Government debt issuance continued and inflationary fears crept into the marketplace keeping rates near multi-month highs. The US dollar lost approximately 4% as the Fed's continued QE2 implementation kept rates low, in direct contrast to rate increases in East Asian countries and tough talk out of the European Central Bank from its head, Jean Claude Trichet, who indicated that Europe would raise rates by mid-2011, making the euro and other currencies) more attractive and higher yielding than the weakening dollar [In fact, Trichet raised rates 0.25% in April]. Even the Japanese yen continued to appreciate against the dollar, and after the earthquake/tsunami, the yen strengthened strongly as currency traders anticipated repatriation of Japanese capital from around the world to repair the earthquake damage, like happened after the 1995 Kobe earthquake. However, the Japanese Central Bank, coordinating with all other G7 nations, intervened in March to weaken the yen (which seemed to stop its multi-year rise) to make Japanese exports more competitive and restart the Japanese economy after the upset of the March natural disaster.

Kanos Quarterly Commentary

"Japan, MENA, and Washington"

Different elements of our current investment strategy have been brought into the headlines in recent weeks. Economic and investment experts are split on the consequences of recent happenings in Japan, the Middle East/North Africa (MENA), and Washington; while not anticipating such stunning happenings, our portfolios have been constructed to try to protect your wealth from risks and rising uncertainty. While your portfolio manager's penchant for value has landed some of our capital in "yet-to-be-realized" positions, we believe our natural resources-dominated, value-oriented portfolios will deliver medium- to long-term appreciation in excess of more traditional investing methods.

Japan – Fossil fuel dependency will increase

Japan is our first case-in-point. While many have still not decided on whether the earthquake/tsunami disaster will have long-term economic consequences for Japan (or the US and the rest of the world), we believe there is one big result that will occur: the re-emergence of growth in fossil fuel usage by the world's economies, and Japan in particular. The destruction or shutdown of a number of Japanese reactors will lead to short-term needs of diesel, liquefied natural gas and coal to re-power Japanese industry and the coming rebuilding effort. In the medium-term, more nuclear plants will be closed due to: 1) unfortunate siting decisions (in natural disaster-prone areas, not only in Japan but in the US and the rest of the world), 2) age (planned decommissioning) or 3) riskiness concerns (need for more redundant systems, like more on-site diesel generators for backup, etc; Germany has already shut down reactors to test for riskiness). Add to these elements the cancelling or delay to building of new nuclear plants, and oil/gas/coal are the largest beneficiaries. Coal is the most prolific energy source on the earth, but its pollution concerns in an increasingly environmentally conscious world will mean that it won't gain as much market share as it would otherwise. Crude oil is by far the most efficient fuel currently in use, and its diesel and residual oil products will be a huge beneficiary of the decline of the Japanese (and to a lesser extent, world) nuclear industry. Natural gas and liquefied natural gas will also be huge beneficiaries, as natural gas is the least polluting of fossil fuels and it is oversupplied in many areas in which it occurs (Qatar, Algeria, Indonesia, Trinidad, New Guinea [just to name a few large sources in lower-usage areas]). North American natural gas, while in oversupply, has no outlet for export to other regions, meaning gas prices in North America should stay low (especially in comparison to energy prices around the world) for at least a year or two to come.

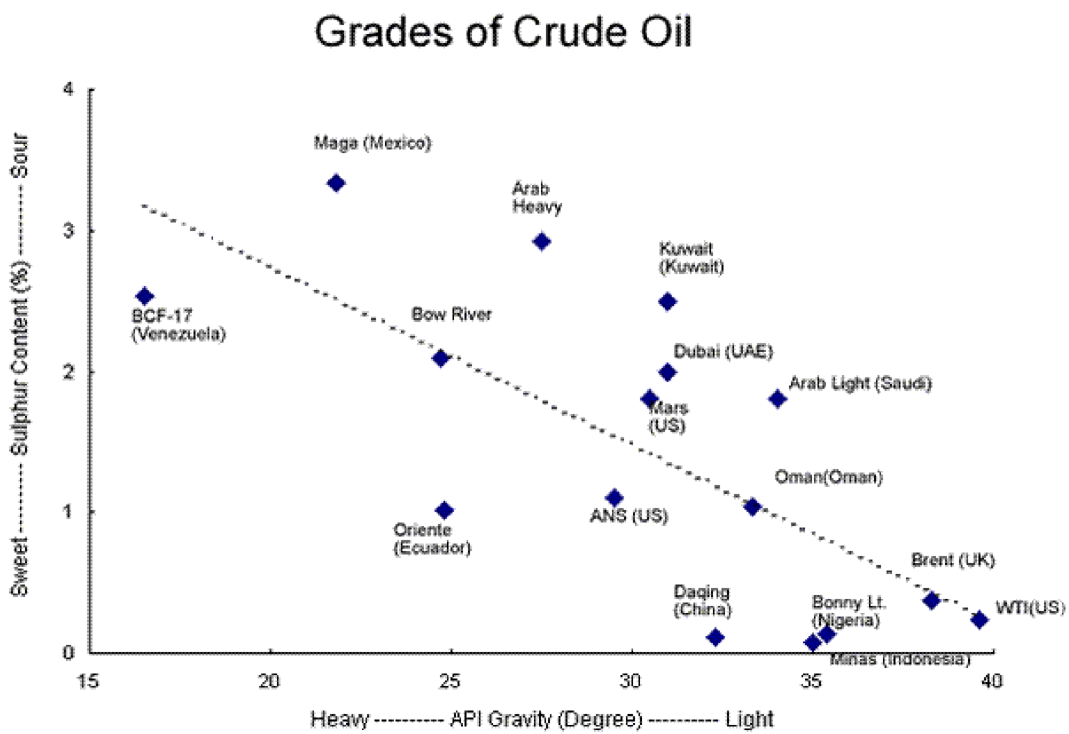
One might ask: what about renewables as a beneficiary? Solar, wind and wave will be helped by Japan's disaster and non-Japanese nuclear concerns and postponements, but renewables have to have fossil-fueled backups, because the wind doesn't always blow or the sun may be obscured by cloud cover (until electricity storage is developed at a cost that makes sense – many years in the future). Solar seems the most poised to be viable in the future; however, currently, according to a recent Raymond James analysis, a home photovoltaic system in California, with a lot of state and federal tax breaks, still requires a $15,000 up-front cost for an average style home that will only be paid back after 9+ years – not a very good value proposition for a very "now" oriented US consumer. Thus, our concentration on energy stocks, especially those that are most crude oil-focused, should be profiting in the future from the shift back to more petroleum usage.

MENA – Food inflation, political unrest and energy supply problems

Droughts, floods and extreme weather in a number of crop-growing locales occurred during 2010 to severely crimp wheat, soybean and corn production around the globe. Worldwide easy money policies meant to head off deflationary pressures primarily in the US and Japan (but transmitted by world trade to Asia and South America) have led to higher prices of many commodities, and the resulting higher food prices touched off the riots in North Africa this winter. These food riots in Algeria, Tunisia and Egypt led to revolutions that toppled the Tunisian and Egyptian regimes, and these results emboldened repressed peoples around the Arab world to try to topple repressive governments.

Libya and Yemen are currently caught up in civil wars, and the Libyan situation is dire for Western Europe because Libyan oil exports are light, sweet crude and natural gas that have a large part in powering southern Europe. Libya has the most impact on European energy concerns, because Libyan Es Sider crude is some of the best quality crude in the world (see the chart below – Libyan Es Sider is not on this chart, but it is better quality than Nigerian Bonny Light, in the lower right corner (the best crudes – high API gravity, low sulfur to have to refine out). Yemen is a small oil exporter, but protests and killings dominate its current politics. This same type of unrest has spread to Bahrain (a small exporter but where Saudi Arabian troops were called in by the Sunni Muslim rulers to put down protest by the Shia Muslim majority population – a very worrisome result), Oman (where the Sultan is an absolute ruler and has large crude oil and LNG exports), Syria (also a small oil exporter but with a brutal history of repression) and even Jordan. The big wild card, of course, is Saudi Arabia where there have been pockets of protest in the eastern section of the country (where all the oil is produced) but King Abdullah has attempted to buy off the populace by distributing cash to all Saudis and embarking on a large infrastructure building spree.

The problem with all of this is that the developed world (especially Europe and Asia) has grown dependent on much of its energy needs from dictatorships in MENA that are now threatened, and new regimes in these countries may have very different ideas about the export of their petroleum resources. The situation highlights three main energy vulnerabilities: 1) **location of oil supplies** – depending on oil supplies from places where you have little or no influence is now starting to look dangerous, 2) **threatened supply/transportation routes** – lots of refiners and chemical plants have been built in Saudi Arabia and other Mideast locations; if these plants are harmed or destroyed, or if supply lines are threatened by hostile rulers or pirates in between their sources and ultimate locations, then those energy supply lines appear increasingly vulnerable, and 3) **dependence on light, sweet crude grades** – Libyan, Nigerian (a source of constant attacks and unrest over the years, which is has just had contentious presidential elections) and some other Mideast crudes (Saudi Light) are light and sweet, which means they are easy to refine into gasoline and other motor fuels and without a lot of sulfur to refine out. Many sources of "spare capacity" of crude oil are heavy, sulfur-laden crude grades (like Saudi Heavy, Venezuelan crudes and Mexican Mayan) and are too thick for many refineries to use.



Source: The International Crude Oil Market Report

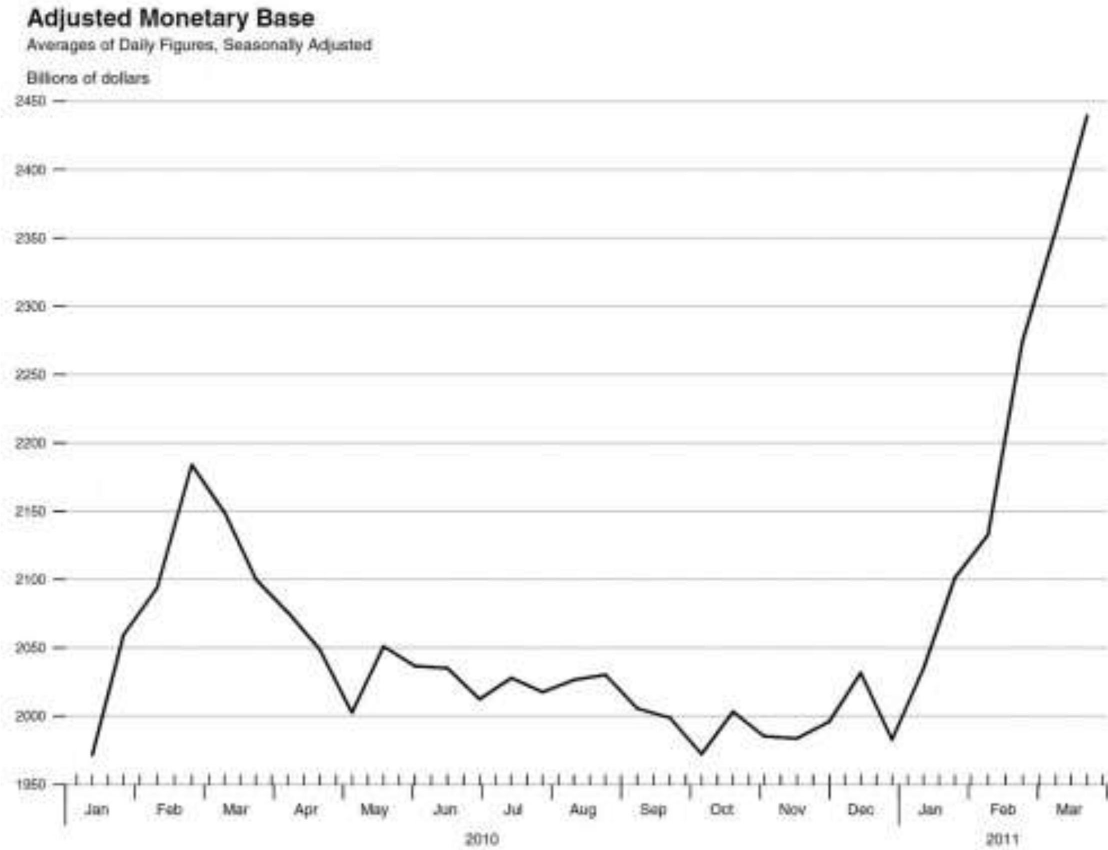
Refineries must be configured to take certain crudes, and it is expensive to build or refit a refinery to use heavy, high-sulfur crudes, especially when refinery profits have been poor during the recession.

Thus, our concentrated positions in Canadian oil sands companies should prove to be even more profitable because: 1) they are situated in arguably the most politically-secure nation in the world, located contiguously along our northern border near many of our large population centers and some refining centers, 2) pipelines, railroads and tanker trucks are stable and efficient means of safely transporting crude oil and natural gas to their North American consumption areas, and 3) these large oil sands companies have built facilities that turn poor quality "bitumen" (an oil-laden rocky sludge) into high quality crude oil, “cooking it” into crude oil using plentiful (and cheap) North American natural gas so that the resulting fuel is of high quality. Crude oil around the world is much more expensive to find and extract than in the past, and the oil sands are increasingly on par with other oil finds for development and operating costs. “Peak oil” has become a reality only due to costs – the world will not run out of oil for many decades, but increasingly, the ability to find, develop and produce oil for less than $80/bbl is fast passing into history.

Washington – Easy money policies will lead to increasing inflation

The unexpected shocks of the abovementioned happenings show the uncertainty of the world and how investment portfolios need to contain holdings that take into effect large unexpected occurrences. This is why we have incorporated precious metals holdings and mining and service stocks into our portfolios. But the reason we have so far overweighted these holdings are the actions (and inactions) coming out of Washington DC (and to a lesser extent Tokyo and Brussels).

The impunity with which the Federal Reserve operates appears obvious to more and more Americans as prices of energy and food rise (as well as school/college tuitions, insurance, healthcare, etc.) while the Fed says there is “no inflationary pressures”. The Fed looks at prices with a large bent toward: 1) housing (or in Fed-parlance, owner-equivalent-rent) and sees that housing prices are weak and getting weaker, 2) wages (with globalization and increasingly efficient world trade, billions of central and east Asian workers have entered the workforce in the past fifteen years) and sees downward pressure put on US wages, and 3) volatile energy and food prices over the years, leading them to look at inflation without these key elements, to try to get a more smooth look at inflationary “pressures”. Thus, the Fed appears to see lower housing and flat to weakening wages, even as the economy continues to grow (albeit slowly) out of the 2008-09 recessionary bottom. The Fed’s QE1 policy started in March 2009 (lasting until March 2010) and helped shock the US out of the trough of the recession (aided by other factors like US government guarantees on financial instruments and the rescue of Fannie/Freddie), which led to a stock market rally. Only weeks after QE1 ended, the stock market peaked, rolled over and headed down during the summer of 2010. QE2 was mentioned in August 2010, and the stock and commodity markets have risen almost constantly since then. The market appears to be anticipating a need for a QE3 or extension of QE2 as it rallies in spite of high oil prices, uncertain world finances, natural disasters, crop failures and uncertain political leadership around the world. The QE2 monetization of US government debt and the large increase in US monetary base (the amount of US dollars available that most economists and macro market participants watch) shown below illustrate the money availability to banks (and thus, the economy) brought on by the QE2 program.



Does the US need a QE3 (or possibly a semi-permanent continuation of QE for months or years)? The Fed sees the QE programs as a way to lower interest rates since it usual tool to move interest rates, the Fed Funds rate, near 0%. If the Fed does not think that the observed rise in commodity prices will affect economy-wide inflation except in the short-term, then Bernanke et al. may well maintain QE to try to support more economic growth and lower employment. Here are two recent articles that show the Fed's views that current commodity inflation is transitory:

Fed's No. 2: Don't blame us for oil spike

By Chris Isidore, senior writer
April 11, 2011

NEW YORK (CNNMoney) -- The Federal Reserve's efforts to pump money into the U.S. economy are not to blame for the rise in oil and other commodity prices, according to the No. 2 official at the central bank.

Fed Vice Chairman Janet Yellen, in a speech to the Economic Club of New York Monday, said that rapid growth in demand by emerging economies such as China are driving up prices. And she argued that the Fed should not need to pull back on its stimulus efforts in order to rein in prices.

Yellen said the Fed's current program of buying up to $600 billion in additional long-term Treasuries and keeping its key interest rate near 0% "continues to be appropriate because unemployment remains elevated."

She added that measures of inflation are still lower than what the Fed usually considers to be stable for the long-term.

Yellen said it is not reasonable to attribute the rise in commodity prices with the 10% decline in the value of the dollar against other major currencies since last summer.

Sharp disagreement among Fed members

She said she doesn't think this current spike in prices will derail the U.S. economic recovery. While high prices for oil, food and other commodities will feed overall inflation over the next few months, she expects consumer inflation will then retreat and remain subdued.

Yellen repeated recent statements by Fed chairman Ben Bernanke, who has maintained that the impact of higher commodity prices on overall inflation to be "modest" and "transitory."

Since businesses are seeing little increases in labor costs due to high unemployment and productivity gains, there are only limited inflationary pressures caused by rising commodity prices, she said.

Yellen acknowledged that some inflation expectations are rising in the short-term, which she said is reasonable in light of commodity prices, but she sees prices remaining stable in the long run.

"Longer-term inflation expectations seem to me to have been roughly constant," she said in response to a question.

Even if inflation continues to rise under pressure from higher gas prices, it wouldn't necessarily mean that the Fed should change monetary policy, Yellen said.

"Such shocks push up unemployment and raise inflation," she said. Tightening by the Fed in response to a price spike, "might mitigate the rise in inflation, but would contribute to an even weaker economic recovery." ■

Bernanke May Sustain Stimulus to Avoid 'Cold Turkey' End to Aid

April 19 (Bloomberg) -- Federal Reserve Chairman Ben S. Bernanke may keep reinvesting maturing debt into Treasuries to maintain record stimulus even after making good on a pledge to complete $600 billion in bond purchases by the end of June.

> The Fed chief's top two lieutenants said this month the economy and inflation are too weak to warrant the start of a monetary-policy reversal. Investors and economists including David Kelly at JPMorgan Funds see that as a signal the Fed will keep its balance sheet at current levels by replacing about $17 billion a month in maturing mortgage debt with Treasuries.
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> Ending the reinvestment policy and the $600 billion program at the same time would be like quitting stimulus "cold turkey," said Kelly, who is based in New York and helps oversee $400 billion as chief market strategist at JPMorgan. "It does make sense to reinvest for a while," he said. "Then they could watch how bond yields react to that."

These uncertainties and money printing programs have forced us to concentrate our portfolios in hard assets, led by precious metals that will hold their values as prices rise due to oversupply of money. Precious metals also are not controlled by governments (although there is a lot of evidence of gold and silver price manipulation by governmental entities over the years), so they should continue to provide protection against bad governmental and central bank policies. The Japanese central bank has "gotten into the act" after their national disaster by providing liquidity to Japanese banks (the virtual equivalent of "printing money") in the past few days that is <u>equal to the entire amount of quantitative easing they provided during the 1990s and early 2000s</u> used to try to get Japan out of its 1989-1995 depression. This shows the instantaneous power that central banks in large industrialized countries have over the world's currencies, price levels, and ultimately savings and investments.

In an interesting recent turn of events, a large institutional pension fund, University of Texas Investment Management Co., the second-largest U.S. academic endowment, took delivery of almost $1 billion in gold bullion and is storing the bars in a New York vault, according to the fund's board:

> **Shortage Threat Drives Texas Schools Hoarding Bullion at HSBC**
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> **April 15 (Bloomberg) --** Dallas hedge-fund manager J. Kyle Bass helped advise the University of Texas Investment Management Co. on taking delivery of 6,643 gold bars, worth $987 million on April 15, now stored in a bank warehouse in New York.
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> Bass, who made $500 million with 2006 bets on a U.S. subprime-mortgage market collapse, said managers of the endowment, known as UTIMCO, sought

> board approval to convert its gold investments into bullion this year. A board member, Bass, 41, said he was asked to help with that process.
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> While Bass, a managing partner at Hayman Capital Management LP, said in an April 16 e-mail that "the decision to purchase and take delivery of the physical gold" was made by endowment staff members, "I helped where I could." Gold futures touched a record $1,489.10 an ounce April 15 in New York before closing at $1,486.
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> The Texas fund's $19.9 billion in assets ranked it behind only Harvard University's endowment as of August, according to the National Association of College and University Business Officers. Last year, UTIMCO added about $500 million in gold investments to an existing stake, said Bruce Zimmerman, the endowment's chief executive officer. The fund's managers sought to take delivery of bullion to protect against demand for the metal overwhelming supply, according to Bass.

As bad as the Federal Reserve decisions have been over the past many years, the inability for US political leaders to control spending and live within our means (not to mention the huge new deficit-spending by the 2008-2010 Democratic-controlled government) is the longer-term inflationary buildup. By having a deficit that is over 30% of total government revenues, the US Government's ability to avoid inflation is almost past. Having Social Security and medical programs that were initially designed for Americans that typically only lived into their 60s and not their 80s/90s means that entitlement reform must be tackled and spending must be cut. If not, the amount of debt that the US has already incurred will grow faster as interest rates rise and debt is issued just to pay interest on existing debt. An interesting perspective of this was recently presented by ex-fund manager Michael Burry, a famous hedge fund manager who made a lot of money for his clients in 2006-2008 by betting against subprime mortgages:

> (ZeroHedge) Michael Burry's ironic plight against pervasive lemming groupthink (such as the one gripping the nation currently) has been well documented in Michael Lewis' "The Big Short." It is thus not surprising that the topic of his April 5, 2011 speech to the Vanderbilt University (of which he is an alum) Chancellor's Lecture series is the current flawed conventional thought paradigm: that of central planning, of quantitative easing and of dollar debasement by the Fed, which are far more dangerous than anything experienced during the credit bubble as when the current regime finally fails, and it will fail, there will be nobody to bail out the US. From Burry's speech: "I am worried about a future of a nation that refuses to acknowledge the true causes for the crisis. A historic opportunity was lost. America has instead

> chosen its poison as its cure... Today I expect the US government to attempt to continue easy money policies into the next presidential term, past the foreclosure crisis, and past the corporate and public refinancing humps that are forthcoming. Junk bonds incredibly are again at all time highs. Quantitative Easing seems to be working for now. But this is an invalid validation of what America is doing. This is in fact a Pyrrhic gamble. As we continue to debase our currency, Bernanke says he is not printing money, again I disagree. As it stands I get an email from the Fed saying we bought another X billion in Treasuries. I don't know - that's pretty clear to me. In fact this program QE2 its scope and breadth raises the severe question of the Treasury's needs. **The government's borrowing of money for the purposes of injecting cash into society, bailing out banks, brokers and consumers, is a short-sighted easy decision for a population that has not yet learned that short-sighted, easy strategies are the route to long-term ruin.** We never quite achieved the catharsis necessary to stoke the reevaluation of our wants, need, and fears. **Importantly, the toxic twins: fiat currency and an activist Fed remain firmly entrenched, even more so with the financial reforms last year**."
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> Burry's practical advice: open a bank account in Canada.

I think one more article here is worthwhile: while this Charles Krauthammer piece will seem to paint me as an arch-conservative (I don't consider myself an arch-conservative except possibly in economic matters), I think it illustrates what is wrong with US Government leadership in general. While Krauthammer concentrates his attacks on President Obama, the argument could be applied to US lawmakers since the 1960s, and more so the fault of Congresses than even US Presidents. I think it is worth thinking seriously about how we need to elect more leaders who will make hard decisions (that will certainly disadvantage most working Americans, public sector and private sector) that will lead to solutions that will make the US a better place to live and do business for us, our children and later generations.

Obama More Like Louis XV Than Reagan

By Charles Krauthammer
02/17/2011
Washington Post

Five days before his inauguration, President-elect Obama told the Washington Post that entitlement reform could no longer be kicked down the road. He then spent the next two years kicking — racking up $3 trillion in new debt along the way — on the grounds that massive temporary deficit spending was necessary to prevent another Great Depression.

To prove his bona fides, he later appointed a deficit reduction commission. It made its report last December, when the economy was well past recession, solemnly declaring that "the era of debt denial is over."

That lasted all of two months. The president's first post-commission budget, submitted Monday, marks a return to obliviousness. Even Erskine Bowles, Obama's Democratic debt commission co-chair, says it goes "nowhere near where they will have to go to resolve our fiscal nightmare."

The budget touts a deficit reduction of $1.1 trillion over the next decade.

Where to begin? Even if you buy this number, Obama's budget adds $7.2 trillion in new debt over that same decade.

But there's a catch. The White House assumes economic growth levels higher than private economists and the Congressional Budget Office predict. Without this rosy scenario — using CBO growth estimates — $1.7 trillion of revenue disappears and U.S. debt increases $9 trillion over the next decade. This is almost $1 trillion every year.

Assume you buy the rosy scenario. Of what does this $1.1 trillion in deficit reduction consist? Painful cuts? Think again. It consists of $1.6 trillion in tax hikes, plus an odd $328 billion of some mysterious bipartisan funding for a transportation trust fund (gas taxes, one supposes) — for a grand total of nearly $2 trillion in new taxes.

Classic Obama debt reduction: Add $2 trillion in new taxes, then add another $1 trillion in new spending and, presto, you've got $1 trillion of debt reduction. It's the same kind of mad deficit accounting in ObamaCare: It reduces debt by adding $540 billion in new spending, then adding $770 billion in new taxes. Presto: $230 billion of "debt reduction." Bialystock & Bloom accounting.

Re-Election In Mind

And what of those "painful cuts" Obama is making to programs he really cares about?

The catch is that these "cuts" are from a hugely inflated new baseline created by the orgy of spending in Obama's first two years. These were supposedly catastrophe-averting, anti-Depression emergency measures. But post-recession they remain in place. As a result, discretionary non-defense budget levels today are 24% higher than before Obama — 84% higher if you add in the stimulus money.

Which is why the supposedly painful cuts yield spending still at stratospheric levels. After all the cuts, Education Department funding for 2012 remains 35% higher than in the last pre-emergency pre-Obama year, 2008. Environmental Protection Agency: 18% higher. Energy Department: 22% higher.

> Consider even the biggest "painful cut" headline of all, the 50% cut in fuel subsidies for the poor. Barbaric, is it not? Except for the fact that the subsidies had been doubled from 2008 levels. The draconian cut is nothing but a return to normal pre-recession levels.
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> Yet all this is penny-ante stuff. The real money is in entitlements. And the real scandal of this budget is that Obama doesn't touch them. Not Social Security. Not Medicaid. Not Medicare.
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> What about tax reform, the other major recommendation of the deficit commission? Nothing.
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> How about just a subset of that — corporate tax reform, on which Republicans have signaled they are eager to collaborate? The formula is simple: Eliminate the loopholes to broaden the tax base, then lower the rates for everyone, promoting both fairness and economic efficiency. What does the Obama budget do? Removes tax breaks — and then keeps the rate at 35%, among the highest in the industrialized world (more than twice Canada's, for example).
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> Yet for all its gimmicks, this budget leaves the country at decade's end saddled with publicly held debt triple what Obama inherited.
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> A more cynical budget is hard to imagine. This one ignores the looming debt crisis, shifts all responsibility for serious budget-cutting to the Republicans — for which Democrats are ready with a two-year, full-artillery demagogic assault — and sets Obama up perfectly for re-election in 2012.
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> Obama fancies his happy talk, debt-denial optimism to be Reaganesque. It's more Louis XV. Reagan begat a quarter-century of prosperity; Louis, the deluge.
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> Moreover, unlike Obama, Louis had the decency to admit he was forfeiting the future. He never pretended to be winning it.

Investing Going Forward

The US dollar has been dropping in value versus most world currencies during the winter/spring. We attribute this to: 1) continued Fed money printing and easy money stance, 2) continued US Government spending and a widening budget deficit (besides all rhetoric to the contrary), and 3) the less certain political circumstances in Washington and state capitals, as Democrats lose hold on their former political control but their leadership is seen as lacking.

Meanwhile, Japan is faced with rebuilding after the earthquake/tsunami damage of March 2011 while its large export sector's competitiveness in world markets is hampered by a strong yen. The Japanese Central Bank, in connection with Japan's Ministry of Finance, looks to try to "kill two birds with one stone" by printing even more yen, thus providing financing for rebuilding and weakening the yen through money printing.

These two overarching currency trends continue to define our investments going forward. With these two of the top three economies printing money in abundance, we believe that precious metals and especially precious metals mining stocks will do extremely well in the future. Mining stocks have lagged as investors continue to be wary of rising costs (energy, labor-related and equipment cost inflation), but rising prices for their metals products should offset much of the cost increases. The largest mining stocks are almost all below their all-time highs, while gold and silver are setting all-time and 30+-year highs, respectively. The rise of commodity ETFs have led investors to buy the metal in a vault rather than ore in the ground, leading to the disparity in mining share movements vis-à-vis metals prices. Buying miners at this stage is buying inexpensive metal in the ground that gives a leveraged return if metals prices rise faster than costs, which we have seen for the past couple of quarters.

While we covered our small short positions in the Japanese yen after the earthquake/tsunami caused the yen to rise due to the thought of Japanese wealth repatriation (as happened after the 1995 Kobe earthquake), now the program to weaken the yen seems to be Japanese government/central bank policy, and so we anticipate participating in this trend by re-establishing short yen/long dollar positions in the future.

With the S&P 500 up almost 100% from its March 2009 lows and trailing P/E multiples exceeding 17x currently, most of the S&P 500 looks unattractive for us. **Financials**, especially, are extremely hard to analyze and we suspect are still full of problematic real estate and leveraged loans, so we see this sector as most unattractive. **Information Technology**, while containing some interesting companies, has a trailing P/E that exceeds 20x, and in a world which has been buying technology products for the past couple of years to increase productivity instead of hiring new workers, we believe the macro tech spending cycle has peaked. The poster child for this trend is Cisco Systems, down more than 15% year-to-date (vs. S&P that is up almost 6%), due to poor sales growth, slipping margins and declining market share. **Consumer Goods** companies (both Discretionary and Staples) have rebounded from their extreme lows and currently sport a 20+ trailing P/E, curiously high for a slow-growth US economy and a tightening interest rate environment in emerging market countries. **Utilities**, while enjoying popularity due to their yields in a low-yield environment, face the potential for rising long-term interest rate increases, hurting future financing costs, and aging infrastructure concerns, especially with a new focus on nuclear facilities – thus, a negative future outlook. **Industrials** have also enjoyed quite a run-up in prices, but with P/Es in the high teens for cyclical stocks in a slow growth world, we would rather see a pullback before investing in these types of stocks.

Attractive sectors to us are: 1) **Metals and Mining**, as mentioned above, although we are less sure about base metals (iron ore, nickel, zinc, lead, etc.) because the risk of slowing emerging markets growth, the driver behind demand for these metals. 2) **Energy**, which we believe has reserves in the ground to be bought for far cheaper than the future finding costs of new petroleum. We are also warming some to natural gas, as the threat of cheap LNG coming to the US disappears with the Japanese nuclear energy situation, and the cresting of the shale gas "wave" of production gains. There is a good chance that usage will continue to rise for cheap domestic natural gas and production growth may start to tail off – this summer will give us some very good answers to the natgas supply/demand situation. Finally, coal, of which we have not been advocates, seems to be moving back toward center stage as more and more governments weigh the future of nuclear power and the political consequences of new nuclear facilities post-Fukushima. 3) **Healthcare** – which has been beaten down by higher costs, much more stringent regulation, fewer engines of innovation and years of stock market underperformance, looks to be relatively less-highly-valued, especially large pharmaceutical companies. Thus, we have invested in some of these companies and continue to be interested in cheap healthcare stocks which we believe might be able to grow, even in the current environment. 4) Finally, **Telecom** – while we are not fans of AT&T (although we are users), we believe that telecom will continue its growth and that the large companies will provide some stability and yield to conservative portfolios.

Finally, we think bonds will be poor investments going forward as inflation grows, inflation expectations grow in the world's economies, and wage inflation or cost-push inflation (the kind of inflation that central banks and economists **do** fear) slows economies worldwide and sends bond yields higher, crushing bond market returns.

In his April 2011 Commentary, "bond king" Bill Gross, who manages hundreds of billions of dollars worth of bonds for the firm PIMCO, wrote these stark words:

> "… if the USA were a corporation, then it would probably have a negative net worth of $35-40 trillion once our "assets" were properly accounted for, as pointed out by Mary Meeker and endorsed by luminaries such as Paul Volcker and Michael Bloomberg in a recent piece titled "USA Inc." However approximate and subjective that number is, no lender would lend to such a corporation. Because if that company had a printing press much like the U.S. with an official "reserve currency" seal of approval affixed to every dollar bill, that lender/saver would have to know that **the only way out of the dilemma, absent very large entitlement cuts, is to default in one (or a combination) of four ways: 1) outright via contractual abrogation – surely unthinkable, 2) surreptitiously via accelerating and unexpectedly higher inflation – likely but not significant in its impact, 3) deceptively via a declining dollar– currently taking place right in front of our noses, and 4) stealthily via policy rates and Treasury yields far below historical levels – paying savers less on their money and hoping they won't complain.** If I were sitting before Congress – at a safe olfactory distance – and giving testimony on our current debt crisis, I would pithily say something like this:

> "I sit before you as a representative of a $1.2 trillion money manager, historically bond oriented, that has been selling Treasuries because they have little value within the context of a $75 trillion total debt burden. **Unless entitlements are substantially reformed, I am confident that this country will default on its debt; not in conventional ways, but by picking the pocket of savers via a combination of less observable, yet historically verifiable policies – inflation, currency devaluation and low to negative real interest rates.** Our clients, who represent unions, cities, U.S. and global pension funds, foundations, as well as Main Street citizens, do not want to be shortchanged or have their pockets picked. It is incumbent, therefore, in order to preserve the integrity of the U.S. Treasury market along with its favorable global interest rates, and to promote a stable U.S. economy, that entitlement spending be reduced, and that future liabilities be addressed in terms of healthcare and Social Security cost containment. You must attack entitlements and make 'debt' a four-letter word." ***[Emphasis is original to the article]***

The Managers of Kanos Capital Management