September 2007 Investor Letter

Then….And Now

Our strategy of investing in commodity-oriented companies whose prospects, driven by increasing commodity prices, would increase with a falling dollar paid off in spades this quarter.

Commodities…Up!

Demand for commodities of all types continued during the summer, pushing up prices of energy products, metals, grains and other basic necessities in spite of historically high prices (which typically dampen demand). Oil in the $70s/barrel range has not crimped demand appreciably either overseas or in the United States. Even in the face of poor housing fundamentals in the US, copper prices rose during the quarter driven by infrastructure demand from developing countries. Worldwide demand for jewelry and rising inflation concerns combined with a weakening US dollar pushed prices of gold, silver and platinum higher after earlier summer weakness, led by India and other traditional gold-buying countries like China.

On the supply side, oil production has seemingly had a hard time keeping up with demand as US supplies in storage fell over most of the quarter, not only in crude oil but in gasoline, too. This decrease in stored supplies has led to a smaller and smaller margin for error if there is a supply upset or new refinery problems. So, energy prices rose during the quarter, supported by some Gulf of Mexico storm activity (although no US facilities were damaged), flat production around the world, and rising geopolitical tension. Prompt crude oil hit an intraday high of around $84, and ended the month at $81.66! Supply continues to be perceived as tight in the US for crude oil, gasoline and heating oil, heading into the winter when demand typically rises strongly due to heating demand. Energy markets continue to be interesting and volatile.

The rest of the world, led by a number of Asian economies, continues its strong economic growth. Booming economies have demanded all the things needed for building out infrastructure – steel, copper, nickel, zinc, lead, gasoline, diesel, tires, etc., as well as workers, who require housing, meat, bread, etc. Underinvestment in the metals mining industry over the last decade has meant that supply has not been able to keep up with demand, and prices, while volatile, have advanced over the last few years. Rising raw materials prices are starting to cause people to grow concerned about future inflation, driving people to buy or invest in tangibles that will hold their value in inflationary times. Thus, gold has hit a 27 year high at $750/oz, copper is threatening last year's high by

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climbing above $3.60/lb, and grains have gone parabolic in price! Wheat is almost $10/bushel (it was $4 earlier this year) as wheat production around the world has fallen due to drought. Corn traded nearly $4/bushel (it was half that not last year) even though the US harvest is larger than last year because demand for corn as food and animal feed has been augmented by corn demand for production of ethanol, using up all the new supplies.

Rates and the US Dollar…..Down!

In the US, the economy was weighed down by the accelerating weakness in the housing market. Falling housing prices have again unearthed problems in the mortgage markets, as homeowners default on overpriced houses and foreclosures climb. Problems in the mortgage markets, where companies have gone out of business and financial institutions (and investor funds) marked down their mortgage bonds, have led to larger problems in the debt and money markets. The problems reached a crescendo in mid-August when commercial paper, which a lot of money market funds buy, virtually stopped trading. The US Federal Reserve ("the Fed") tried to help restore confidence by lowering its "Discount Rate" in August, but it didn't seem to help the commercial paper market appreciably. Thus, to try to perk up the slowing economy and "kick-start" the commercial paper and money markets that were suffering from a lack of confidence and liquidity, on September 18th the Fed lowered their targeted "Federal Funds" interest rates 0.5% (this rate is widely for trading among banks).

The Fed's decision to lower interest rates and by a larger than expected amount <u>shocked</u> the markets and led to worldwide opinion that the dollar, already quite weak, would not attract as much investment in the future as it had in the past due to lower interest rates in the US compared to Europe and parts of Asia. Thus, the dollar fell in relation to other currencies.

The stock market reacted favorably as traders felt that the Fed's rate cuts would lead to lower borrowing costs and therefore faster US economic growth, while the lower dollar would make US exports more competitive, allowing US exporters to build market share abroad. However, the downside is that high prices for commodities has been caused in large part by booming <u>demand</u>, and since most commodities are priced in dollars (but used around the world), a lower US dollar means that commodities are cheaper for international consumers. Lower prices stimulate more demand abroad, putting further upward pressure on prices. So the Fed rate cuts lit a fire under commodity prices, and already high priced commodities rose strongly, as did the companies that produce them and the industrial companies that are associated with their production. Metals, materials, and especially energy prices rose strongly.

The Die is Cast

The Fed had been painted into a corner – if they raised rates to quell inflation, they might hurt the economy, especially since higher rates would further hurt the very weak housing situation in the US. If they lowered rates (much of the rest of the world has been raising their interest rates due to booming economies and rising raw materials prices), then lower interest rates would cause international investors to feel like the US markets have less attractive interest rates (pushing international investors to invest in higher-rate currencies abroad), thus hurting the exchange rate of the US dollar and possibly leading to higher long-term interest rates. As the economy showed signs of increasing slowing in August/September, the Fed finally had to tip its hand, as it could not sacrifice the US economy to save the US dollar.

The US Dollar Index, an index used for almost 40 years, is now at an all-time low. This extremely low US dollar level is less attractive to international investors, who have been investing more than $600 <u>billion</u> each and every year (the US current account deficit), and have allowed US interest rates to stay low, helping maintain US economic growth. However, less attractive interest rates will lead international investors to buy fewer US dollar bonds, and when these international investors try to sell their dollars, the US dollar will fall further in price. As mentioned above, a further weakened dollar will make dollar-denominated commodities more attractive to the rest of the world, and raw materials prices should continue to climb.

Why should we care? A lower dollar is usually thought of as a way to stimulate demand for US goods abroad, thus helping US economic growth. The problem is that we have been living in the past decade with a relatively strong dollar, allowing US consumers to buy imports from around the world at reasonable prices. Prices of imported items, whether they be cars, toys, consumer goods, etc., will cost more with a lower dollar. Items that trade in international markets, including energy products, agricultural products, and most raw materials (copper, steel, iron ore, etc.) will cost more as international demand competes further for limited supplies.

Thus, we see increasing inflation at a time when the US housing market is continuing to weaken. Demand for goods and services around the rest of the world will continue to be strong when compared to the US economy. The US economy will teeter on the brink of recession as the housing and auto industries continue to be weak, but the rest of the US economy keeps growing.

Thoughts for the Future

The stock market will have bouts of weakness when uncertainty about debt markets cause investors to panic and sell. However, we also believe that the weak dollar will make America look like it is having a “half price” sale on everything, including its companies and real estate. We expect international investors to use their dollars which they have built up over the years to buy US real estate and US companies. Protectionism will be part of the equation, but a steadily weakening dollar will allow foreigners to pay higher and higher <u>dollar</u> prices that will eventually quell opposition to sales of US entities.

We will continue to invest in securities we think will appreciate due to higher product prices, growing profits and/or attractiveness to buyouts buyers. In addition, we will avoid investing in areas where we think there could be more weakness: financials, retail-oriented companies and consumer discretionary. We will probably continue to favor some kind of hedging short position, either against general market weakness or housing / housing finance continued weakness. Remember, the re-setting of "teaser" rates for adjustable rate mortgages will not reach its peak until the January-March period of 2008, so we will probably not know the extent of the problem until next summer.

Final Thoughts

The Fed has eased interest rates when the stock market was within 5% of its all-time highs, having set highs in July and then again in September after a "rocky" August. For the Fed feel like it must lower interest rates and stimulate the economy while commodity prices are historically high, the stock market is near its all-time peak and much of the rest of the world is growing strongly in multi-year trends means that the US housing and manufacturing sectors are extremely weak**.** The Fed has signaled that they must save consumers' housing investments by lowering rates to make short-term borrowing cheaper. This is a reaction that we believe will have major long term ramifications. No matter what you hear or read, inflation will only build from here. Raw materials, labor and foodstuffs are attracting such strong demand from developing countries that their prices in US dollar terms will not fall much in the near future, even if the US does go into recession. This inflation will damage fixed income financial assets, especially those denominated in dollars. Companies which need to use raw materials to produce their products could see margins squeezed if their US dollar-denominated prices cannot be raised at least as fast as raw material prices are rising. We must be positioned to protect our capital – and we will be by investing in commodity companies, precious metals, cash and very few bonds, financial companies and retail companies.

The Managers of Kanos Capital Management