KANOS CAPITAL MANAGEMENT, LLC

Third Quarter 2011 Investor Letter

Third Quarter Market Conditions

The third quarter was extremely volatile with 100+ point moves in the Dow Jones Industrial Average almost the norm. The US stock markets hit their year-to-date lows in early August and revisited those lows near the end of the quarter. On the flip side, long-term bonds continued to rise in price, sending yields to or near multi-decade lows due to fears of global economic slowdown and deflation.

July was a market "down" month, with the S&P 500 shedding more than 2% for the month, led down by industrials (down more than 7%), health care stocks, financials and telecoms. Weak economic statistics, punctuated by an almost flat employment report, caused investors to sell stocks, causing money to move into more traditional "safe" investments like cash, bonds and precious metals. The precious metals gained for the month, with gold jumping to a new record near $1630/oz and silver moving back to $40/oz as European financial worries caused more capital to move into hard assets. Oil also stayed strong, with West Texas Intermediate (WTI) Crude finishing July near $96/bbl.

August was one of the wildest months on record. Not only did the deficit ceiling debate end with a whimper, but Standard & Poor's downgraded the credit of the United States Government after little deficit reduction was "accomplished." Meanwhile, the East Coast was hit first by a powerful earthquake and then by a powerful hurricane, and the financial markets were stormy themselves; the S&P 500 was down 5.5% (led down by energy and financials, both down around 10% for the month). The bond market, after reacting to the downgrade, proceeded to zoom higher as the European fiscal situation continued to deteriorate and capital fled the Continent. Precious metals benefitted from the uncertainty, with gold climbing above $1,900/oz at one point and silver cresting above $43/oz before both settled at lower levels at the end of the month. The month was a true rollercoaster ride, with numerous multi-hundred point gain and loss days on the Dow Jones Industrials.

September was a continuation of August, with weakness prevailing throughout much of the month. US stock market indices oscillated along with sentiment, ending September on a down note as Europeans continued to grapple with their deteriorating fiscal circumstances. The "touch point" of the month was the Fed's mid-September meeting where, instead of announcing a new dose of quantitative easing, the Fed said it was going to be changing the duration of its Treasury holdings from shorter-term to longer-term. The Fed program, known colloquially as 'Operation Twist', is a redux of an early 1960s

1177 West Loop South, Suite 1750, Houston, Texas 77027 Phone: (713) 963-9631
Mobile: (713) 305-4001 Fax: (713) 963-9920 E-mail: kirby.shanks@kanoscapital.com

Fed operation which also bought long-term and sold short-term Treasuries. At nearly the same time, the Swiss fixed their currency to the Euro. Counterintuitively, many investors interpreted this move as gold bearish, as the Swiss were pledging to create more and more Swiss Francs, abandoning their traditional solid money stance. This led to the quickest, most severe sell-off in the gold and precious metals shares witnessed in almost 30 years. Money flowed into the US Dollar and US Treasuries, as panicked traders reached for anything they judged stable. With the panic and Operation Twist, long-term Treasuries soared, with 30-year bonds dropping to a 2.90% yield (down from 4.40% at the end of 2010) and the 10-year yield dropping to 1.92%. Stocks experienced a horrible month in spite of a mid-September rise. Industrial commodities suffered. Gold and silver, after the late month slaughter, recovered more than $100/oz and $4/oz, respectively, from their late September lows. Gold stocks did better, retaining some of their gains from earlier in the quarter.

Precious Metals

For the quarter, the metals acted very differently. Gold hit a new high amid panic in the Eurozone, then experienced a correction in August and the late September steep drop. However, gold ended the quarter up more than 7% at $1,620/oz. Silver, platinum and palladium, all of which had been strong earlier in the year, ended lower in the third quarter, as fears of economic slowdown led to selling, with silver ending more than 10% lower at just over $30/oz.

Despite two large corrections during the quarter, we believe that gold prices have "weathered the storm". For much of the quarter, gold prices were strong in the face of lower stock prices and Eurozone worries, as gold was judged to be a haven for capital. In late September, after the extreme sell-off, the gold price found support at/around the 150-day moving average, just as it had done in February 2010, March 2010, July 2010, and January 2011. Since the price downdraft in late September, gold again has shown that it was more of a store of value than other commodities and most equities.

Gold mining shares, after underperforming for most of 2011, far outperformed other equities through much of the third quarter. Gold mining was the top performing sector in the US stock markets, with the S&P Gold Mining Group gaining 11.53% for the quarter. Yamana Gold, Newmont Mining and Eldorado Gold were large gainers in the group. Gold mining stocks were up on a half-dozen large down days in the stock market during the quarter. Except for the week in September, the shares performed admirably as ballast in a stormy US stock market environment.

Russian, Thai and Bolivian central banks all added significantly to their gold reserves during the quarter, continuing the trend of net central bank purchases of gold. Amounts sold by other central banks were minimal. Indian and Chinese purchases of physical gold and silver for investment purposes and jewelry continued to be very strong, with the

World Gold Council reporting that "[t]hese two markets accounted for 52 per cent of global bar and coin investment and 55 per cent of global jewellery demand and year-on-year volume growth in total consumer demand was 38 per cent in India and 25 per cent in China, compared with a global growth rate of 7 per cent." We see both bank and consumer demand in these markets continuing to drive price appreciation as long as central bank policy remains skewed toward easy monetary policies.

Energy

The energy complex suffered along with worldwide stock markets as traders judged crude oil and energy share prices would drop with demand during worldwide economic weakness. As European fiscal woes overlaid fears of an Asian slowdown, energy prices were driven relentlessly lower, despite other factors signaling prices were near bottoming. West Texas Intermediate (WTI) crude fell from $95/barrel to just under $80/bbl at the end of September, while Brent crude, a more worldwide "marker" of crude oil, fell only $9.72 to end near $102.76. The pricing of crude oil futures, which is in "backwardation" for Brent crude (meaning crude oil for immediate delivery costs more than that deliverable in the future), is signaling rising demand for crude, while the price itself has fallen sharply. Historically, backwardation signals demand outstripping supply, which we expect will result in higher prices in the future. In the meantime, WTI crude prices have been weaker as "shale oil" discoveries in the US (especially in the Dakotas), coupled with Canadian oil sands crude, has led to a glut of oil in the central USA. Brent pricing has continued to be at a large premium to WTI (which historically had traded at a slight premium to Brent due to its higher grade), again signaling European and Asian demand for lighter, sweeter crude oil grades still missing from the market, most notably from the near absence of Libyan crude oil, which is often substituted by users of Brent.

Natural gas, which we have shied away from owning in our energy picks, continued its 2011 weakness. In spite of an extremely warm summer throughout the south central US, the continued drilling of "shale gas" has kept supply deliverability high, keeping a lid of prices under $4/MMBtu.

Other Markets

As mentioned above, longer-term bonds outperformed every other asset class, with a large assist by the Fed (they will buy more long-term bonds in Operation Twist). Corporate bonds were generally higher, paced by their comparable-maturity Treasuries, but high yield bonds, like equities, had a very poor quarter. International equity markets dropped even more than US equities, led by European markets where both the German DAX index and French CAC-40 plunged almost exactly 25% during the quarter, accompanied by Russia (down 30%, dominated by oil firms). Emerging markets equities, which had performed so well in the past, dropped 23% during the quarter (as

represented by the MSCI Emerging Markets index). The some of the better performances during the quarter included Hong Kong (down 21%), Korea (down 16%) and Brazil (also down 16%). Slowdown fears continue to haunt these markets, driving scared capital to the US bond markets, in spite of all of their inherent problems.

Focus Stock

We are instituting a new section that highlights a stock in our portfolio on which we would like to update our investors. This quarter we highlight **Newmont Mining Corporation (NYSE: NEM)**, currently the only precious metals mining stock in the Standard & Poor's 500 Index. The company is a large mining company with worldwide operations, with mines in Nevada, Australia, Peru, Ghana, Indonesia, Mexico and exploration sites in other countries.

Newmont has a long history and is one of the "majors" of the industry. However, the company's growth stalled in the 2007-2009 period, leading to lower profits. The lack of growth was compounded by rising costs and disappointing operations. Management has changed, and we believe Newmont has turned the corner. Profits are up 27% year-over-year and up 49% on average over the past five years, while sales growth is 10-20%, showing the company is executing. Its operations seem sound and much more reliable than in the past.

Growth is still the big "question mark" for the stock. Through development of current and surrounding properties and targeted acquisitions (including Fronteer Gold, which was in some of our portfolios), growth (in production volumes) is expected to be at least 5% through 2014. The company's sales will generate enough cash to execute operations, cover all capex planned, and still have almost 50% of cash available for possible future acquisitions.

Newmont is very attractively valued, with a 14.5x trailing P/E ratio and a 2012 P/E projected at 10.5x. Trailing and forward operating cash flow ratios are both approximately 6.0x. It trades at approximately 2.5x tangible book value, but that comes out at approximately $350/oz of proved and probable gold-equivalent metals in the ground. Even with Newmont's mining costs of approximately $500/oz, this is an extremely attractive valuation for buying gold which trades in the spot market for $1,620/oz currently.

Finally, to highlight Newmont's cash generation ability, management pledged this past summer to a new dividend policy, linking the dividend to the gold price ($0.20 per $100 change in the price of gold), Newmont is projected to yield between $1.40-1.80/share, for a dividend yield near 2.5%, which is very attractive in this environment, especially when it is supported by the gold price and compares to a 1.92% ten-year Treasury yield.

Going Forward

We have been investing your capital in a more concentrated manner recently as we see less and less attractiveness to other sectors in the financial markets. We have observed that so many supposedly "diversified" investments have tended more and more to trade together, thus nullifying one of the large benefits of diversification. Now comes confirmation that correlations among 'diversified' asset classes are even higher than we thought. As reported by CNBC on 9/13, ConvergEx Group in a note to clients said, "[t]he average correlation between the 10 major sectors in the S&P 500…is at a mind-boggling 97 percent…[e]very sector, including utilities, has a correlation above 90 percent." In addition, and even more disconcerting, "[d]eveloped markets outside of the U.S.…have a 96 percent correlation against the S&P 500 index…[and] [e]merging markets – as measured by the iShares MSCI Emerging Market ETF – are 97 percent correlated to the U.S. market. High yield corporate bonds move in the same direction [as] the S&P 500 index 89 percent of the time."

These very high correlations have meant that diversification hasn't been very helpful, except if you concentrated your positions in bonds, most notably Treasury bonds (see discussion below). Instead of a broad diversification, we have adopted a "barbell" approach to equity portfolio construction which we believe will, over time, react better than many portfolios to the uncertainties facing world economies today. We have concentrated one "end" of the barbell in precious metals sectors that have historically done better than many stocks during times of deflation; metals and mining stocks allow us to keep exposure to attractive supply/demand fundamentals and participate in companies with worldwide markets, not just domestic or developed country demand.

The other "end" of the barbell has been invested in energy related investments that should benefit from any economic growth in Asia (and eventually the developed world) and from attractive supply and demand fundamentals.

The "in-between" part of the barbell is invested in dividend-paying blue chip stocks and some other low valuation stocks. We currently plan to stay away from more uncertainty-laden sectors (financials, consumer discretionary stocks, etc.), keep some exposure to more defensive sectors (health care, consumer staples) and to concentrate in natural resource sectors which allow us to protect capital over-time, keep exposure to attractive supply/demand fundamentals and participate in companies with worldwide markets.

We continue to be worried about the struggling US economy, bloated US Government spending, the increasingly insular and unresponsive political process and, most concerning, the fiscal problems in Europe.

Europe is a "slow-motion train wreck" which has no easy solution, and time only makes the inevitable that much further off. In a nutshell, many of the countries in the European

Union have intractable fiscal situations: Greece, Ireland and Portugal have existing debt and budget deficits that are unsustainable and almost certainly will lead to default by those countries' governments, possibly as soon as in a few short weeks. Italy and Spain, with larger and more diversified economies, are in very poor fiscal shape, have high debt levels and could default on their debts without reforms. Another significant problem with these PIIGS (Portugal, Ireland, Italy, Greece and Spain) nations' finances is the lack of ability to help their banks if the need arises. In the past, the tried and true recipe for countries in these situations was to devalue their currency to make their costs lower and their exports more competitive, all the while printing enough currency to pay off governmental debt; however, with no control of the Euro, the PIIGS are stuck with a strong currency, unpayable debts and little hope for quick economic recovery.

Germany and France, the two largest countries and the main architects of the EU, have more manageable debt levels but cooling economies. They would like to see the EU stay together so they can continue to sell their goods throughout Europe, the main reason these two countries have been economically strong since the advent of the Euro. It looks like these two leading countries are committed to staying with the Euro and although they would like to keep the EU together, it increasingly looks like it will be very expensive. The European Central Bank (ECB) is set to try to keep price stability in Northern Europe while trying to have easier monetary policy in Southern Europe (they are buying bonds of these countries to try to add liquidity), a balancing act which is getting very difficult. Currently the plan to save European banks (and to a lesser extent, the sovereigns themselves) is the European Financial Stability Fund (EFSF) and its larger future version, The European Stability Mechanism (ESM). The temporary EFSF (to be followed by the permanent ESM in 2013) is the legislatively-mandated "bailout" mechanism, charged with making long-term loans and/or buying long-term bonds from European banks and countries themselves (essentially doling out "doses" of quantitative easing). The EFSF was formed by all 17 Eurozone countries and funded by members pro-rata (based on the size of their economies). Most market participants think of it as a "Euro-TARP", so since it's passed all the hurdles for its formation, it has inspired some short-term confidence of the banking/fiscal situation allowing Europe some breathing room. In our minds, the "jury is still out" on whether this mechanism will inspire long-term confidence or even work longer-term, especially since the size is currently less than €450 billion.

All in all, we expect the banks of Europe to ultimately have to be rescued by their governments as the defaults by southern European governments and banks gut the equity of the northern and southern European banks alike. The EFSF and ESM are currently not big enough to tackle the problem debt of Italy and Spain, especially if the other three PIIGS use up all the current EFSF capacity (a distinct possibility). We don't believe the slow-moving European responses will solve the underlying problems; they are merely short-term relief of longer-term problems. It seems to us that **different cultures with different fiscal disciplines cannot run their economies under a common monetary regime in times of economic uncertainty/turmoil**.

In addition, we believe the PIIGS will probably all end up leaving the EU, meaning there will have to be months of negotiations to engineer that which had not been contemplated (on purpose) – exits from the EU. We believe it will lead to continued volatility and lower prices in the Euro and European securities in general, which should be supportive of the US Dollar and US equities, precious metals and the Swiss Franc and Swiss securities (in spite of the current currency "peg" of the Swiss Franc to the Euro).

Precious Metals

As gold and gold mining shares have, on balance, behaved very well during the most recent worries in both Europe and Asia, we believe we should continue to keep larger-than-normal allocations to this pivotal group.

Continuing economic uncertainty and slowdown fears worldwide mean investors will continue to hunt for safety as well as return for their capital. Worldwide monetary authorities have continued to pursue easy-money policies, as economies worldwide have been slow to return to self-sustaining growth. We believe that the Fed still has monetary stimulus available and that it intends to implement more of it, given the economic woes in the US and around the world (see Kanos Quarterly Commentary below).

While precious metals mining shares performed well on a relative basis to many other stock groups during the 3rd quarter, they still ended September at a nearly 19% discount to their normalized value in comparison to gold prices (and with gold at $1,620/oz in the analysis). We continue to believe investors will further recognize the attractiveness of growing revenues from higher gold volumes and future higher prices, which yield cash in the form of dividends. Smaller exploration companies will be revalued as growth is constrained and acquisitions start to proliferate. We continue to support an overweighted position in this sector.

Energy

We at Kanos have stayed with an overweight energy position, and our portfolios have suffered from recent price action. Traders continue to be nervous about a possible Chinese economic "hard landing" and developing European (and possible US) recession, meaning lower energy prices. The eventual resolution of the Libyan civil war is also expected to put much more "premium" grade oil back on the market, possibly leading to lower prices.

However, a number of fundamental factors point toward future strength in the oil-oriented energy complex. First, the shape of the "curve" of future oil prices generally demonstrates what industry participants are forecasting for future prices. Currently, the oil price curve is in a situation called "backwardation" where future prices are lower than

more current prices. The expectation of future prices is determined by the near-term "spot" prices, so currently, the industry is "demanding" oil for prompt delivery, more so than oil stored for delivery in the future. This is a very bullish stance because prices are "pulling" oil out of storage – a condition that usually indicates that no more oil deliverability is available. This is especially true in both southern Europe, in spite of supposedly imminent reestablishment of Libyan supplies. US supplies, concentrated around Cushing, Oklahoma (where WTI futures are delivered), trade at a large discount to world crude oil prices but have a virtually flat price curve, also signaling relative strength. Second, storage of crude oil and refined products (gasoline, heating oil and diesel fuel, primarily) is showing supplies dropping over time, again supporting the backwardation signal of tight supplies. These tight supply indications have existed during much of the third quarter, but they have intensified during September, leading us to hold onto our oil-oriented energy positions. With a continuing La Nina situation in the Pacific Ocean currently predicting a colder-than-normal winter in North America/Northern Europe, we believe oil and oil-related companies should benefit from increased activity and higher prices.

Natural gas in the US is another story – still a victim of its own success, a hot summer and an already cool October have not been enough to even support natgas prices at $4.00/MMBtu, leading to extremely poor natgas company stock performances. Since we have underweighted natgas in our portfolios, our positions have not suffered in line with many natgas-oriented companies. However, we still do not see natgas prices recovering substantially unless the 2011/2012 winter is another much-colder-than-normal winter which requires extremely heavy usage of North American natural gas. Otherwise, natgas prices will only be supported by reduced deliverability due to reduced drilling activity – a situation frequently predicted but so far not yet realized.

Other Markets

Long-term bonds, the clear victors in the third quarter and for much of 2011, are priced for perfection. With the latest reading of the Consumer Price Index coming in at an annualized rate of 3.8% during a time of economic stagnation and expected continuing easy money policies of central banks around the world, a ten-year bond with a yield to maturity of 1.92%, creates a negative real rate of return of almost 2% [and a thirty year bond with a yield to maturity of 2.9% has an almost 1% negative real rate of return]. Therefore, these bonds seem like a poor investment for the future. We will be looking this quarter at putting some cash to work in floating-rate debt (which shouldn't suffer much if interest rates rise, as we expect) as a way to start earning more income from our more liquid balances.

Quantitative Easing: Its History and Consequences

One main premise backing our investment stance is the large and rising amount of money in the world financial system. We have written numerous times about the US Federal Reserve and its actions; this quarter we would like to expand the conversation to look at central banks around the world and their actions increasing money supply, with an emphasis on quantitative easing.

The term 'quantitative easing' has been used to characterize the actions by the Bank of Japan during 2001 when it bought Japanese Government Bonds (JGBs) to bring down government bond rates in an attempt to jump start the economy through lower interest rates and increased liquidity.

Quantitative Easing went mainstream in 2009 when the US Federal Reserve implemented its own version of quantitative easing meant to reinvigorate the US economy after the deep recession of 2008/early 2009. The Fed bought medium-term Treasury notes to lower rates and to provide more liquidity to an economy they judged vulnerable to deflation. The Fed also bought mortgage bonds in order to re-liquefy bank balance sheets and clear out what were judged by many bank customers and trading counterparties as "toxic bonds" that few wanted to own.

Then last year at the Federal Reserve's yearly conference in Jackson Hole, Wyoming, Bernanke previewed what was dubbed 'QE2', a new program of quantitative easing that involved growing the Fed's balance sheet by another $600 billion through monthly purchases of Treasury, US Agency or mortgage bonds which was intended to help further liquefy the financial system and provide monetary stimulus through lower rates. [The program itself actually "kicked off" in early November, after the election.] Through the Fed's pronouncements, it is also believed that the Fed hoped much of the money would go into the stock market, driving up stock (and other asset) prices, making the "wealth effect" work toward a more sustained economic recovery.

The US programs of quantitative easing managed to lower interest rates and led to higher asset prices, especially in US stock markets. But the downside was that many commodities went up in price, price inflation heated up and the US Dollar dropped in price versus many currencies, making exports more competitive but causing inflationary forces throughout the world. The Fed has been criticized in many quarters for unleashing inflation and providing so much liquidity at virtually no cost (near-zero interest rates), and much of this criticism has come from abroad. But meanwhile, quantitative easing has expanded to new programs.

The Japanese were the first to implement a new regime of quantitative easing following last year's Jackson Hole meeting of central bankers. Their actions were chronicled by Dennis Gartman in his 9/19/2010 The Gartman Letter:

> "Exactly what did the Japanese government do on September 15 [2010]? The Japanese Ministry of Finance directed a reluctant Bank of Japan to buy dollars in large quantities to arrest the deflationary appreciation of the yen that was underway. **This amounted to a second round of quantitative easing** ***[Emphasis mine – KS]*** because the proceeds of the dollar purchases by the Bank of Japan from banks and companies inside Japan were left in the financial system and not "sterilized"--that is, offset by sales of government securities, as has almost always been the case with Japan's previous interventions. Instead, the Bank of Japan printed the money to finance these purchases. Japan wanted the $23 billion worth of dollar purchases (with more to come) to spill into purchases of domestic goods and services, and perhaps into purchases of domestic and foreign bonds.
>
> The initial impact of Japan's intervention was positive given its reflationary objective. There was an immediate 3 percent drop in the yen's value versus the dollar, from just below 83 yen per dollar to about 85.5 yen per dollar. Japan's stock market rose by about 4 percent as shares of exports rose. These responses, given the size of the intervention, are modest. **More unsterilized intervention will be needed for Japan to make significant progress in its battle against accelerating deflation."** ***[Emphasis mine – KS]***

Sure enough, the Japanese Ministry of Finance and Japanese Central Bank did not believe their September actions were enough. The Yen did not depreciate and Japan's export economy continued to suffer from competitive issues worldwide because of high prices caused by the high Yen exchange rate. In an article from Marketwatch.com on 10/05/2010 titled "Japan Reinstitutes ZIRP and Quantitative Easing", Daryl Montgomery describes the actions of the Japanese:

> "In what is being billed as a surprise move, the Bank of Japan (BOJ) lowered interest rates back to zero and is planning on more quantitative easing…On October 5th, the BOJ announced that it cut interest rates to 0.0% to 0.1%. Rates had been 0.1% since December 2008. Japan had previously maintained a zero interest rate policy (ZIRP) between 2001 and 2006...The Bank of Japan also announced a $60 billion quantitative easing program that will purchase government bonds, commercial paper and corporate bonds. Last month, the Japanese government announced a 915 billion yen stimulus package. The Japanese economy has been in the dumps for 20 years and stimulus programs, super low interest rates, and quantitative easing hasn't fixed it. Yet, despite encountering failure over

> and over and over and over again, the government still repeats these same actions with the belief that somehow they will work this time."

As 2010 turned to 2011, the Yen while fluctuating in a range still did not depreciate and Japan's economy continued in its moribund state. Then disaster hit in the form of the Japanese earthquake and resultant tsunami in early March 2011. The Japanese monetary authorities felt compelled to act once again to intervene after Japanese insurance companies and populace repatriated investments they had made overseas, selling in the investments' currency and buying Yen to bring back to Japan for rebuilding after the earthquake. This action drove the Yen even higher and forced the Japanese to sell Yen to try to lower its value. In an article from BusinessInsider.com on 3/14/2011 titled "Bank Of Japan Expands Quantitative Easing Program With Cash Injection Of 10 Trillion Yen", Gregory White shows what Japanese monetary policy makers did:

> "The Bank of Japan has expanded its liquidity injection to 15 trillion yen, or $183 billion, according to Bloomberg.
>
> That number is more than twice the earlier injection of 7 trillion that shook the yen earlier today. ***[This was a separate currency intervention to try to lower the yen's value done the same day in concert with the liquidity injection – KS]***
>
> The reason for the sudden jump in size is a 10 trillion yen increase in the bank's asset purchase program. ***[This is the increase in quantitative easing – KS]***:
>
> The BOJ will increase buying of government debt in the fund by 500 billion yen and boost purchases of short-term government securities by 1 trillion yen. Corporate debt will rise by 1.5 trillion yen and it will also take on an additional 450 billion yen in ETFs and 50 billion yen in Real Estate Investment Trusts, today's statement said." ***[Notice the Japanese even bought equities, in the form of REITs, showing how other central banks (namely, the Fed) may extend quantitative easing in the future. – KS]***

Thus, Japan has instituted more and more quantitative easing during the past twelve months which is designed to provide more liquidity to the Japanese economy and head off deflation [trying to inflate the currency to raise domestic prices in the economy] and secondarily trying to weaken the Yen to kickstart Japan's exports.

Quantitative easing has not been confined to Japan and the US. Europe, which had housed more "hard money" advocates in its central banking establishments, has generally kept their central banks out of supporting the economy, due mostly to the mandate of most European central banks to tailor monetary policy to maintain "price stability".

However, as European fiscal concerns drove Europeans to find safer havens for their money besides the US Dollar and Euro, the Swiss Franc rose sharply due to its reputation as a haven for capital. And, of course, Switzerland is not part of the European Union or on the Euro, so it had to try to solve the problems of large Euro inflows to its economy. Switzerland relies on financial services and manufacturing exports for the majority of its economy, so a rising Swiss Franc led to a slowing economy as Swiss exports became much more expensive around the world. The Swiss National Bank (or "SNB", Switzerland's central bank) had intervened on and off over the past year or two by selling Swiss francs into the foreign exchange (FX) markets, but this intervention had failed to slow the rise in the franc. SNB President Philipp Hildebrand on September 7, 2011 shocked the world and instituted a peg of the Swiss Franc to the Euro at a rate of 1.20, driving down the value of the Swiss franc. A Goldman Sachs report of that day as reported by Tyler Durden of Zerohedge.com describes what happened and its consequences:

> "The SNB committed this morning to a minimum EUR/CHF [Swiss franc] exchange rate of 1.20. Such a one-sided commitment implies a willingness to undertake unlimited CHF selling intervention and hence unlimited FX reserve accumulation.
>
> "This is a credible policy as long as the authorities are prepared to accept the liquidity implications of this potentially very large intervention. However, given the SNB's recent commitment to oversupply the CHF money markets with liquidity, the new policy mix is consistent and can potentially be maintained until inflationary pressures materialise." ***[It was later reported that the SNB balance sheet ballooned 50% in size in late September as a result of money created defending the currency peg – KS]***

So the Swiss National Bank has committed to creating as many Swiss Francs as needed to keep the Franc weak against the Euro, pumping Francs out and causing inflationary pressure and lower Franc values. Sounds kind of Japanese, doesn't it?

The European Central Bank (ECB) has been much more vigilant about inflation than any of its "brethren" as it has been dominated by the German Bundesbank thinking that inflation was evil, as evidenced by Germany's hyperinflation during the Weimar Republic in the 1920s. This thinking dominated the Bundesbank during the postwar period, and the attitude has been a hallmark of the ECB during its entire 14 year existence.

However, the fiscal troubles of Europe, most notably represented by rising borrowing costs for European countries (especially the PIIGS) have started to "chip away" at the ECB's inflation fighting resolve. The ECB set up a "Securities Markets Programme"

(SMP program) in May 2010 in which it would buy bonds in order to restore depth and liquidity to European sovereign debt markets. While this mission is different from US and British quantitative easing programs in its mission, it is essentially the same outcome. While the ECB maintains that it "sterilizes" its purchases (sells a like amount of other securities when it buys sovereign bonds), its open liquidity operations virtually neuter this argument. After initial purchases in early May 2010 of €15 billion of sovereign bonds in the first week (mostly Greek and Portuguese debt), the ECB had not really used the SMP program until August 2011. Then they really started buying: the second week of August included €22 billion of Italian and Spanish bonds, followed by weekly buying of between €7 - 15 billion, bringing its six-week purchase total to over €80 billion. That is a lot of liquidity and approximates the size of Fed purchases under its QE2 program of 2010/2011. In addition, the EFSF / ESM mechanism (detailed above in the "Going Forward" section) make available for lending and/or bond purchases as much as €440 billion, which could multiply the effect of the new Euros produced by the ECB.

The British economy, also sputtering along and still recovering from a burst real estate bubble and high unemployment, was not going to be left out. The Bank of England (BOE) had originally announced a bond buying (quantitative easing) program in 2009 in which it bought £200 billion of assets, mostly government bonds, between March 2009 and February 2010 in an effort to "boost spending and stave off deflation." Just after the quarter ended, on October 6, 2011, the BOE announced a new round of QE: as chronicled by the Wall Street Journal in its 10/6/2011 article "Bank of England Expands Quantitative Easing":

> "The Bank of England said Thursday it will buy £75 billion of government bonds in a fresh bout of quantitative easing aimed at stimulating the U.K.'s stagnant economy.
>
> "The U.K.'s central bank said its Monetary Policy Committee agreed to finance a second round of asset purchases with newly-created central bank money to ensure that the inflation rate didn't fall below its 2.0% target over the medium term.
>
> "The pace of global expansion has slackened, especially in the United Kingdom's main export markets," the BOE said in a statement.
>
> "Vulnerabilities associated with the indebtedness of some Euro-area sovereigns and banks have resulted in severe strains in bank funding markets and financial markets more generally. These tensions in the world economy threaten the U.K. recovery."

Additionally, and also on October 6, the ECB (after they left interest rates unchanged) revealed during the after-meeting press conference that it was providing 12- and 13-month long-term refinancing operations (LTROs) which were, in one analyst's opinion, a

"big deal" and "the closest anyone will ever see the ECB come to doing QE." The LTROs are significant, according to financial analyst Bill Fleckenstein:

> "….because any one of the 7,500 banks that have access to the ECB can take any eligible collateral and the ECB will lend it however much it wants at fixed rates for 12 months and then 13 months (though haircuts will apply, depending on the collateral). The net effect, while not Bernanke-style QE, is that this is the closest the ECB can get (for now anyway). So while they aren't permanently buying bonds, as the Fed does, once the ECB has done this, it could always decide somewhere down the line, when the next crisis hits, that it will unilaterally extend these facilities indefinitely. Thus, if it were to do that, it will effectively have monetized them."

Thus, the ECB, after being the tightest central bank, is slowly embarking on more and more monetary operations to try to liquefy and support the economies of Europe as they weaken during the financial crisis.

Finally, on October 10, 2011, as we were going to press, China entered the "asset purchase arena." In a 10/10/2011 article titled "Beijing Will Buy More Shares In China's Biggest Banks", the Financial Times reported:

> "Central Huijin, the domestic arm of China's sovereign wealth fund, will buy shares to help stabilize the pillars of the country's financial system, the official Xinhua news agency said on Monday…Although Chinese growth has so far held up well, the European debt crisis and the risk of a double-dip recession in the US have cast a shadow over the country's economy…The government, through Huijin, is already the majority shareholder in all of the country's major banks. While the announcement gave no details about how much more it intends to buy, it was unabashed in declaring that it aimed to halt the roughly 30 per cent slide in bank stocks in recent months."

If China moves from its tighter-money regime to an easier money stance (as this action seems to indicate), the world may get even more monetary stimulus than it had anticipated.

So, what is the Fed's next move? As mentioned above, the Fed announced its Operation Twist, which we believe is mildly easier policy (because the demand for the short term Treasuries means that the Fed's purchase of longer-term bonds removes riskier maturities and replaces them with shorter-term Treasuries experiencing higher demand from risk-averse investors). So far, the program has produced higher bond prices, but they have not "trickled back" much into the economy. The Fed's stated purpose is to lower long-term Treasury rates to project those lower rates into consumer loans on mortgages and other

long-term lending, but if economic weakness continues into the late fall/winter months, we believe the Fed will feel compelled to add to its asset purchase programs**.** ***[The early October release of the minutes of the September Fed meeting provided more evidence of this. From the minutes: "A number of participants saw large-scale asset purchases as potentially a more potent tool that should be retained as an option in the event that further policy action to support a stronger economic recovery is warranted." – KS]***

Conclusion: These numerous examples from around the world show a preponderance of easy money policies and their continuing expansion. Central bankers, in spite of their denial of political influence, continue to want to ease policy to "juice" economic growth through higher prices and quickening money velocity. We at Kanos feel like the current makeup of Federal Reserve leadership (Chairman Bernanke, Vice Chairman Janet Yellen and New York Fed President Bill Dudley) are monetary "doves" that will continue to push for easier money to help the US economy grow faster. We don't believe that easier money leads to economic recovery, but with careers devoted to easier money policies and Europe and Japan continuing to promote easier monetary policy, it sure seems like the Fed will want to keep the US competitive in the world economy with accommodative monetary policy, some inflation to show at least nominal growth, and a "not-too-strong" US Dollar which will stay competitive with the depreciating Euro and the eventually depreciating yen.

All these actions point toward continuing inflationary pressures – again confirming our bias toward metals and other natural resource investments. Governments intervening in markets continue to make traditional stock picking less relevant and investing for capital safety and long-term preservation more important.

The Managers of Kanos Capital Management

© Copyright, Kanos Capital Management, 2011. All rights reserved.