KANOS
CAPITAL MANAGEMENT, LLC

Third Quarter 2013 Investor Letter

Portfolio Comments

> "Anyone can see the pinecones in the tree. [Few] can see the trees [or] the forest in the pinecone." Everett Klipp, master grain trader, in *The Dao of Capital: Austrian Investing in a Distorted World* by Marc Spitznagel.

At Kanos, we take our mission to protect and grow your capital very seriously, and always try to look to the long-term in formulating our strategy. The quote above struck us as an illustrative metaphor for our process – trying to imagine the trees inside today's visible incarnation of the pinecone.

Benjamin Graham, in his investment classic, *The Intelligent Investor,* helps us detail more of our approach:

> "Let us … [c]ompare the holder of marketable securities and the man with an interest in a private business. We have said that the former has the *option* of considering himself merely as the part owner of the various businesses he has invested in, or as the holder of shares which are salable at any time he wishes at their quoted market prices.
>
> "But note this important fact: The true investor scarcely ever *is forced to sell* his shares, and at all other times he is free to disregard the current price quotation. He need pay attention to it and act upon it only to the extent that it suits his book, and no more. Thus the investor who permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a disadvantage. That man would be better off if his stocks had no market quotation at all, for he would then be spared the mental anguish caused him by *other person's* mistakes of judgement."

We believe the market is mispricing a number of stocks, some far too richly and some much too cheaply. We own what we consider to be good companies at excellent valuations that, in many cases, have gotten cheaper. We own these companies because we believe the risk/reward going forward is skewed greatly in our favor. Right now, the market disagrees, and many market participants (more as speculators than as true investors) own stocks like priceline.com, Amazon.com, Netflix and Tesla where there is revenue growth but "stratospheric" valuations. Historically these high valuations have led to large sell-offs when market conditions deteriorated and/or company fundamentals didn't live up to heightened expectations.

In this quarter's letter, we will review the past quarter, give our views about our investments' potential and present this quarter's commentary "The Fed Is Trapped."

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Third Quarter Market Conditions

In July, the US stock market rebounded from a tepid June performance with a strong, across-the-board rise. All major sectors of the S&P returned between 4-6% during the month, except for telecoms which were slightly positive. Precious metals, energy commodities and stocks rebounded strongly from their second quarter underperformance. Emerging markets stocks followed the US lead, rising after June's poor performance. US bonds continued their underperformance, falling during July as international US Treasury holders were net sellers and rates continued to rise. Emerging market bonds followed their countries' stock markets up, with slight gains for July after an early sell-off.

August was a very different month than July, as US stocks declined across the board. Materials stocks performed the best, although precious metals stocks gave back some gains late in the month. Energy and Technology stocks also had smaller losses for August, while Financial, Consumer Staple and Utility stocks performed the worst. US and emerging markets bonds fell, extending their multi-month trend, with the 10-year Treasury reaching a mid-month high at 2.90% and closing at 2.75%, the highest in two years. Both Japanese and European markets were also lower. However, the real carnage was in emerging markets stocks; many markets were down more than 10% for the month, although a late August surge recovered some losses. West Texas Intermediate (WTI) crude oil reached a high above $112/bbl in late August as fears of a regional escalation of the war in Syria combined with supply disruptions, spiking oil prices.

September was another turnaround month – stocks across the world rebounded, bonds were up slightly and metals and oil were lower. The month's action culminated on September 18th when the Fed surprised the markets and decided not to taper their monthly bond purchases, propelling virtually all assets worldwide higher in the aftermath. US stocks were led higher during the month by Industrials and Consumer Discretionary stocks while Energy, Consumer Staples and Utility stocks lagged and Telecoms fell. Overall, the S&P 500 ended up 3.14% for September. Virtually all US and European bonds were slightly ahead for September, rescued from another losing month by the Fed's "non-taper". The real standouts in September were peripheral stock and bond markets, which rebounded from poor summer performances to lead the gainers at the end of the third quarter: Greece's Athex index was up 12+% for September, followed by Spain's IBEX (+11%), Russia's Micex (+7%) and Brazil's Bovespa (+4%), all coming back from large losses sustained earlier in the summer. Some developed markets also outperformed, with Japan's Nikkei up 8%, Germany's DAX up 5% and Hong Kong's Hang Seng up 5%. Peripheral Europe and emerging markets bonds were generally up between 2-5% for the month. Most of these markets hit their monthly highs just after the Fed's announcement, falling for the last ten days of the month. Precious metals, after hitting summer highs in late August, fell back during much of September, but were bolstered mid-month by the Fed's continuation of its easy monetary policy. WTI Crude oil weakened during much of the month, but stayed above $100/bbl (as did more expensive Brent).

Most markets seemed to act "tired" toward the end of September, anticipating political uncertainty around the US budget, the debt limit fight and Germany's formation of a new government after Merkel won the September elections (as expected) but failed to gain the majority needed to form a non-coalition government. Sure enough, the shutdown of the US government in early October and the lack of a formal government formation in Germany have extended September equity market weakness around the world into October.

Equities

Equities continued their advance during the quarter, reaching their highs in September following the Fed meeting and dropping the rest of the month. The S&P 500 returned 5.24% during the quarter, and was led by stocks in the Materials (+10.3%), Industrials (+8.9%), Consumer Discretionary (+7.8%) and Health Care (+6.8%) sectors. Lagging sectors included Telecoms (-4.4%), Utilities (+0.2%) and Financials (+2.9%) – all interest-rate sensitive sectors (telecoms are similar to utilities and are generally considered yield plays) that suffered from higher rates during the third quarter. As mentioned above, international markets generally recovered May/June losses during the third quarter, gaining anywhere from 5-15% depending on the area.

Precious Metals

As you may recall, precious metals sold off to multi-year lows at the end of last quarter, weakened by perceived US and Asian economic growth, a lack of measured inflation and the thought that world central banks were guiding developed world economies to self-sustaining recoveries. After reaching a low of $1,180/oz, gold strongly rebounded during July as the abovementioned conditions proved to be unattainable – US economic growth was uneven, led by disappointing job growth statistics and poor retail sales and company reports. Unrest in Syria pushed gold to a late August high of $1,434/oz, but fear of Fed tapering led traders to sell gold in late August and September, pushing prices into the low $1,300s/oz. The Fed's continuation of its bond buying helped push gold and silver to their largest one-day gains of the year, but as Syria fears eased, gold prices fell back to close the quarter at $1,328/oz, while silver ended at $21.69/oz, from a late June bottom of $18.17.

Energy

Crude oil recovered from its second quarter slump, jumping back above $100/bbl for WTI in early July and reached its highs in late August on a combination of factors. The use of chemical weapons in Syria led to a worldwide outcry that was expected to result in a regional escalation of fighting. However, a lack of clarity around the incident led to a standing-down of Western military strike planning. Supply problems also contributed to higher crude prices: Libya experienced strikes and production problems which dropped their production to about 25% of capacity and Iran's production ebbed as Western sanctions make oil production maintenance and development problematic. Finally, the flow of new and recently reversed pipelines has allowed US Midwestern crude to flow to Gulf Coast refineries, giving a boost to WTI pricing which has been held down by end-market constraints caused by formerly inadequate pipeline systems. WTI closed September at $102.29 after trading as high as $112.24/bbl in late August. Natural gas was very volatile, but prices were virtually unchanged from June as US production continues to grow and end-use varies with weather (a relatively cool July dropped prices, a hot August boosted them higher). Natgas closed September at $3.56/MMBtu

Bonds

US Treasury bond prices continued their slide in July and August, bottoming in early September with yields almost reaching 3.00% for the 10-year Treasury (yields briefly touched 2.98%). However, following some uneven economic statistics and the Fed meeting on 9/18 (leaving monetary stimulus unchanged), bond prices moved higher (and yields fell) into the end of the month. In spite of the action in Treasuries, corporates and high yield bonds performed much better on a relative scale, tightening the spreads between Treasuries and other types of bonds – with high yield bonds becoming very highly valued compared to historical levels. Municipals performed poorly all quarter through early September but were able to recover much of their losses during the remainder of September.

Other Markets

European and emerging stocks and bonds rebounded during the quarter, as related above, with a gangbuster September highlighting the recoveries from earlier year losses.

Going Forward

The markets have had a lot of stops and starts during the summer and early fall. We believe the Fed's decision to keep monetary accommodation in place during its September FOMC meeting marked an inflection point that many market participants will have to factor in going forward (although it may not be obvious quickly): the easy money will continue, and the effects of this policy have not all been seen yet. The October nomination of Janet Yellen to be the new Fed Chairperson reinforces this point; much of Yellen's rhetoric for the past decade has been in favor of extremely "easy" monetary policies. The ramifications are large, and coupled with political uncertainty currently in the US and starting to percolate again in Europe (Merkel's incomplete victory in Germany, parliamentary infighting in Italy, events in Greece heating up again, etc.), we believe investors will look to protect themselves more in the future, as valuations have gotten stretched and opportunities are no longer as lucrative. Thus, we see longer-term investors tending to steer future investments to less risky countries, companies and credits and moving to more asset-rich holdings including precious metals, real estate and art/collectibles.

Bill Fleckenstein, hedge fund manager and financial markets pundit, wrote a commentary on his blog in late September that we believe is a good summary of current conditions and coincides with our thinking in many ways. He wrote:

"I thought it might be worthwhile to take a step back and try to assess the big picture, as I believe we might be idling up to a rather large inflection point, i.e., the beginning of the end of the central bank print-fest-inspired levitation of financial markets. By that I mean, if the Fed has lost the bond market -- which is my belief, though we can't be certain yet -- then interest rates will rise despite whatever the Fed does, which will have very negative ramifications for the stock market and the economy. Combined with the speculation we have seen, as typified by Tesla, LinkedIn, Trip Advisor, Facebook, Yelp, Zillow, and other wild, kinky stocks of this era, when equities do finally top out (if they haven't already), computers will get loose on the downside at some point ...

"This is the third bubble-like experience that we have had in the last 20 years. The first was the equity bubble, and the clues to that ending were the separation between the crazy and sane stocks in late 1999-2000, followed by the blow-off in March 2000. The end was somewhat recognizable at the time, but given that the stock market was the epicenter, it was the stock market itself that had to provide the signs that the end was nigh.

"As for the real estate bubble, where the bust broke wide open in 2008, the early clues that the end was at hand came from the subprime market, which was where the marginal buyer operated. In early 2007 we saw the initial first-payment defaults, and that was the tipoff that the marginal buyer had been found and could not pay. That was the end of the subprime market, which marked the beginning of the end of the real estate bubble. And yet, even though the real estate market *was* the economy during the middle of the last decade, it took from March (when the first-payment defaults began) until [October 2007] to finally put a top into the stock market, although it wasn't until 2008, when the real damage was done.

"As for the post-2008 period, money printing on the part of the Fed and other central banks has powered the stock market higher and helped the economy to some degree (e.g., by driving the real estate market), but it has really been a result of ridiculously low interest rates (not just short-term rates, which the central banks control, but longer term rates as well), which has provided the impetus for all the levitation I just described.

"If the bond market (i.e., five years and out) is no longer willing to follow what is dictated by short-term rates and the central banks, then higher yields lie ahead. Since no one really expects that, higher rates will wreak havoc throughout the financial system and various economic structures. At some point the realization that the Fed no longer controls interest rates will cause a "reset" in the stock market, which will be quite a bit lower. I expect the Fed to fight this eventuality with even more money, but of course that won't work, though it will be beneficial for precious metals.

"In short, over the course of the next month or so we will find out just what the bond market wants to do, but I expect the current rally to fail, and that the key to when trouble starts will be when 10-year government bond yields climb back over 3.00%.

"Getting the Federal Reserve out of the money printing and day-to-day jawboning business and back to some sound standard is what we all need in this country. The discipline that that will create will finally force Congress to make the painful adjustments to get our financial house in order. This is not going to be easy or happen tomorrow, but I believe that is where we're headed."

Equities

We think the confirmation of easy money policies will impact investors' perceptions of inflation and safety. As those perceptions come to the forefront of investors' minds, different sectors of the stock market will benefit than have recently. So far this year, equities, while correcting slightly at times during the year, have continued to move higher, albeit on diminishing volumes and with narrower leadership (fewer stocks making new highs). The extreme valuation for high revenue growth stocks in the social media, cloud computing, biotech, online travel and exotic technologies sectors is reminiscent of the 1960s computer company mania and the 1990s dot.com extreme valuations. Many of these companies, while exhibiting sales growth that is hard to find these days, do not produce income currently and, statistically, many never will. While these situations seem very attractive on the way up, most will see losses in excess of 67% when the mania breaks and former "investors" dump these high-flyers for safer homes for their capital. Most other stocks in "growth-y" sectors in US markets are at the very high end of historical valuation levels, but stocks have continued to be the most sought-after asset class due to dividends exceeding 10-year Treasury yields (at many large companies), companies' perceived ability to grow revenues and earnings consistently, and continued high profitability levels. One of our main concerns is that profit margins are 70% above historical averages. Margins have always reverted to (or gone below) their historical averages over time. When profitability starts to falter, stocks will be shown to be expensive at present levels.

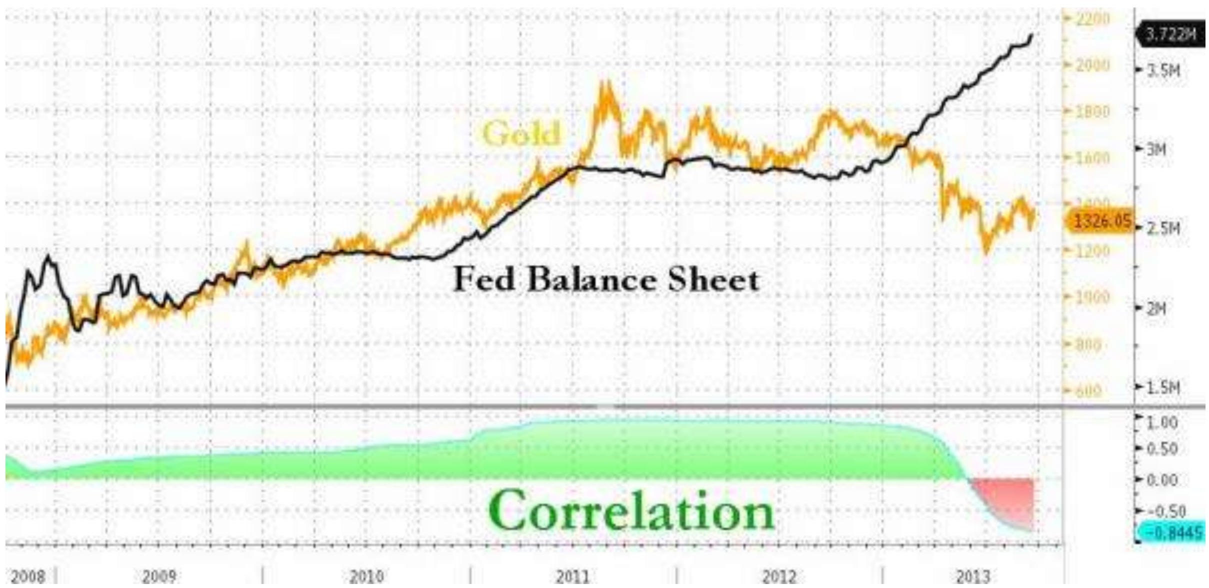
We still see attractive valuations in a number of sectors, but many of these sectors are out-of-favor and some are economically dependent, meaning we will need to see more economic recovery before we feel comfortable investing your capital in these situations. We have continued to look and invest selectively in companies and sectors we believe are good values and will continue to be good businesses far into the future. We continue to comb through screens and recommendations to find attractive opportunities.

Precious Metals

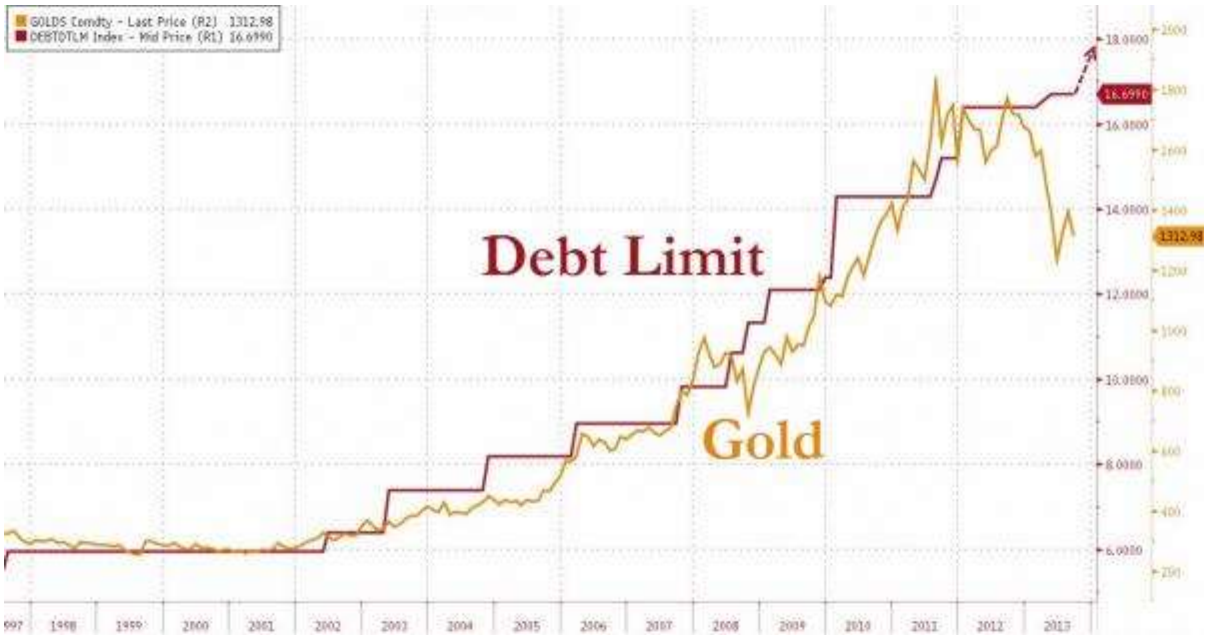
Precious metals prices have moved higher off of earlier year lows, but have not built on those gains in a sustained way since late August. We believe the Fed will continue monetary stimulus in the same large amounts at least into 2014. The Japanese government has determined it must try to raise revenues through a higher sales tax, and so they are constructing more fiscal and monetary stimuli to try to offset the effects of the higher sales tax rates. The European Central Bank (ECB) has been able to maintain a relatively tight monetary stance, but we believe they will have to try to stimulate moribund economies and will use monetary policy as one of their policy tools. So easing will continue, and while it has had limited positive effects for precious metals so far in 2013, we (and a number of others) believe that the rise from the late June 2013 bottom will continue as liquidity continues to build on bank balance sheets.

JP Morgan Chase in late September issued a research report advocating the buying of gold going forward due to the Fed's continuation of its current monetary policy (as well as Japan's and other central banks' monetary easings). They cite the correlations of gold's price to three things illustrated in the graphs below (taken from the report):

1. Gold's price correlation to the size of the Fed's Balance Sheet

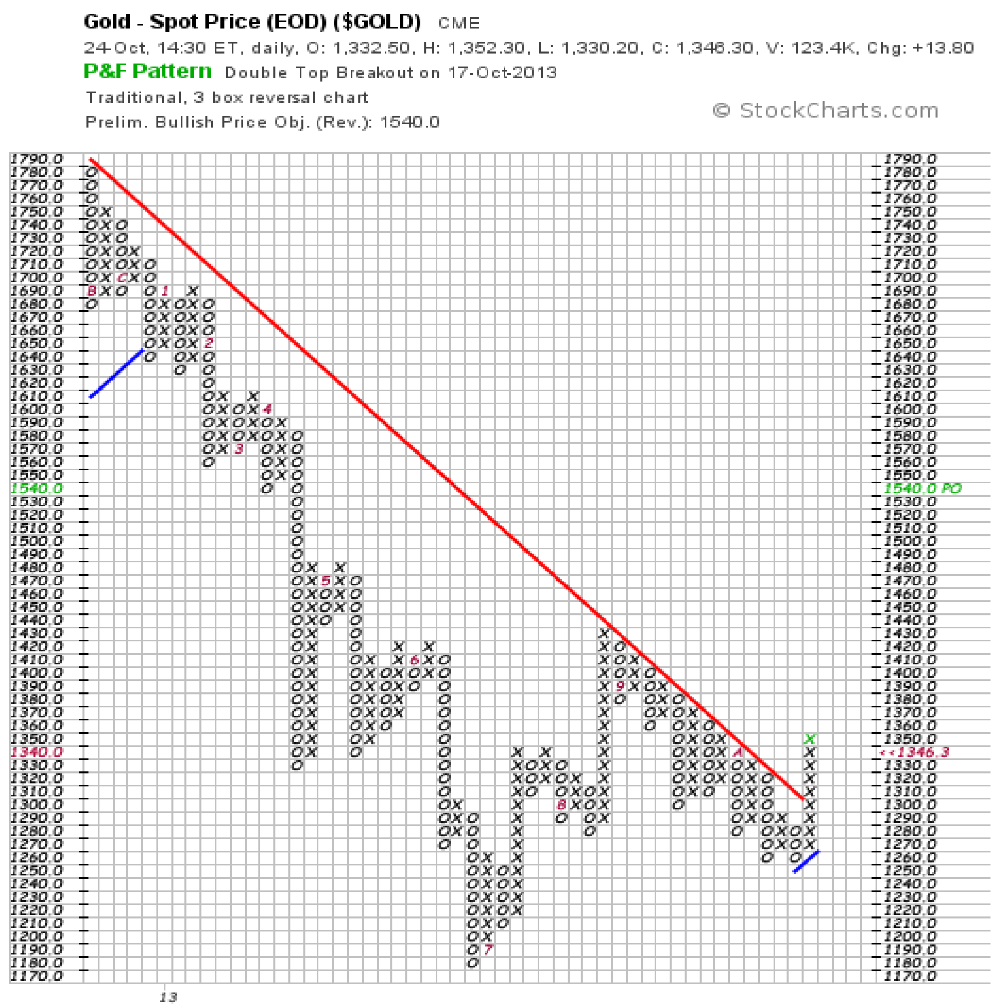


2. **Gold's price correlation to the size of the US Government's Debt Limit**



3. **Gold's price correlation to the size of worldwide central banks' Balance Sheets (combined)**

Metals prices were weak through the first half of October because the US government shutdown contributed to the slowing US economy and caused people to reconsider the deflationary pressures of the slowing growth and disruptions to the economy. However, by mid-October, as the markets realized the economy was weaker than expected and QE could possibly last into 2Q 2014, gold rallied strongly. We believe the force of the money creation worldwide will have a strong effect on the precious metals in the near future. The following chart is a "point-and-figure" chart that shows larger price trends through the use of advances (x's in the diagram) and declines (o's in the diagram). It shows that gold has been relatively weak since hitting an interim high last fall, but has threatened to break that downtrend for the past several months. Finally in mid-October, the trend looks to have been definitively broken, and we believe it has confirmed our call that the late-June 2013 lows will prove to be the lows for years to come.



Energy

Oil prices have been elevated this year due to constantly growing world demand and supply disruptions in North Africa and the Middle East. Meanwhile, US oil produced from shale basins has continued to grow strongly, providing North America with plenty of oil and allowing US refineries to export gasoline and diesel fuel to worldwide markets. So far, prices have stayed between $100/bbl and $110/bbl for months, although African (Libyan) and Middle Eastern (Iraqi and Iranian) production levels seem to be returning to pre-summer levels, indicating possible weakening of crude oil prices this quarter. Natural gas prices have stayed in the $3.25 - $3.75/MMBtu band during the last few months, although increasing production levels from shale basins in the Northeast (especially the Marcellus Shale) seem to indicate weakening prices going into the winter. We have not raised our allocation to energy equities, fearing the return of crude oil supplies to the market and the inability of demand to take up the slack. Balancing this concern is the continuing radioactive pollution troubles at Japan's Fukushima nuclear plant, which virtually guarantees that Japan's nuclear power plants will stay idle and that Japan will rely on continued large petroleum and petroleum product imports for the country's energy needs, providing extra demand. We will be curious to see if other countries start to try to wean themselves from nuclear power, especially if oil and gas from shale starts to be produced by countries besides the US. Mid-October mild weather combined with fewer supply worries have pushed WTI prices below $98/bbl, and discounts for North American crude that cannot get to world markets in Western Canada and places in the US upper Midwest is probably closer to $80/bbl. We think that oil will stay on the weaker side, staying in the $90s/bbl or possibly above $100/bb at times, but with ample supplies becoming more of an issue in the future.

Other Markets

The US bond market, headlined by the US Treasury bond market, will be a huge focus of financial markets going forward as investors try to gauge how much rates could rise and whether continued "application" of quantitative easing will keep long rates in check (or not). After rates rose from "taper talk" in May through the September Fed meeting, the surprise continuation of QE announced at the September meeting stopped the rate rise. However, 10-year Treasury rates have only fallen around 0.25% since then, only a small fraction of the 1.40% rates have risen since May 1st. We believe the threat of inflationary pressures will cause 10-yr T-bonds to creep back toward their September highs around 3.00%, possibly eventually causing the Fed to increase bond-buying to keep rates below that 3.00% level for longer-term Treasuries (which are used to price lots of other debt instruments, including most long-term mortgages).

Foreign stock and bond markets could benefit from a weaker dollar (due to continued QE), allowing profit margins to expand as interest rates fall back and imports become cheaper (due to appreciating currencies compared to the dollar). Higher profits would lead to higher stock prices and attract capital back to foreign fixed income markets which was lost during the summer when people thought US rates might continue to rise as the Fed would lessen stimulus. So we may see a reverse in the summertime drops in emerging stock and bond markets.

Kanos Quarterly Commentary

The Fed is Trapped

The Fed's policy-making committee, the Federal Open Market Committee (FOMC), met in mid-September to review the economy and to decide whether to change monetary policy (or not). This meeting was one of the most anticipated meetings in recent years because of prior Fed communications about the possibility of changing the amount of monetary easing (currently $85 billion per month). The Fed had first discussed a possible change (almost certainly a decrease) in the amount of easing in its May communications, and this reduction of easing seemingly ended the nearly 31-year-old bull market in bonds, as bond yields shot higher during most of the next three months. The threat of more restrictive policy (less buying of bonds) roiled the markets all summer, led by the bond market but also affected the stock market; the bond market went almost straight down, as did rate-sensitive stocks and many economically-sensitive stocks, including many in emerging markets (as noted above in the Third Quarter review).

However, on September 18th, the Fed shocked most market participants by announcing NO tapering of monetary easing, concluding that the economy had not improved to the point that monetary stimulus needed to be removed. After an initial jump higher on the news, financial markets fell in the next two days, giving back all the gains from the Fed's decision and reflecting investors' and traders' fears that the Fed had just "gotten it wrong" and would quickly taper starting in late October.

We believe the market is putting too much credence in the FOMC members' speeches in which they continue to talk about tapering. Instead, we believe the Fed will not act anytime soon. **We believe the Fed is trapped into continual easing going forward.** Quantitative Easing (QE) was meant to be a program that provided extra monetary stimulus to allow the US economy to grow its way out of its post-2008 malaise, partly by suppressing interest rates and partly by raising asset prices, both of which were expected to entice companies to hire more workers, borrow money and expand their enterprises.

So far, asset prices have risen (most US averages hit new all-time highs after the Fed's September announcement, bettering early summer highs). Un-anchored long-term bond rates, in spite of the Fed's buying each month, have risen since the Fed warned of tapering starting in May 2013 and have only retraced 25 basis points of its 140 basis point rise in rates (since May) after the Fed did not taper in September. There are a number of other reasons we believe the Fed will not discontinue its quantitative easing, and while it may try to taper purchases in the future, we believe the reaction would leave the Fed having to re-instate the discontinued purchases **or possibly even increase quantitative easing to keep yields from rising.** The extreme could be that the Fed "pegs" some long-term rates (such as the 10-year Treasury bond) in which it continues to buy bonds until its target interest rate is maintained. This is not without precedence, as it was done during World War II.

Here are some of the reasons we believe the Fed cannot discontinue quantitative easing:

1. Employment – Earlier this year, Chairman Bernanke tied the Fed's monetary policy to unemployment rates, setting the target at 6.5% before the FOMC would consider raising rates, and 7.0% before it would (probably) start to ease off on the amount of QE. The market seemed to like this type of targeting because it appeared to cut down on the uncertainty of how the Fed would act. However, two elements of the unemployment numbers have clouded the issue: **labor force participation** and **types of jobs created**. Bernanke targeted the "U-3" measure of unemployment, which counts only people employed or actively looking for a job – however, the labor force participation, which shows how many people are employed or looking for a job as a percentage of the eligible work force **just set a 35-year low,** meaning that **the reason the unemployment has fallen slightly in the past few months is due to the fact that the amount of people employed as a percentage of the eligible workforce has fallen**. Thus, unemployment has "improved" far less than the headline reports indicate, forcing the Fed to continue policies to enhance employment. Second, quality of jobs has fallen appreciably – the largest group of new hires (by far) in the past few months is bartenders/waiters, which are mostly part-time, low-paying jobs. The manufacturing sector has actually lost jobs, and they are typically full-time, skilled, highly-paying jobs. So, while the economy has cut down the U-3 unemployment number, net new jobs barely offset population gains and many of the new jobs are low-paying. Bernanke and the Fed do not see this as enough of a positive to stop easing policy (and in fact, he even referred to this **as a problem** in his question-and-answer news conference following the announcement of the September 18th FOMC "non-taper" decision).

2. Housing – Part of the recovery during the past couple of years has been a recovery in residential real estate prices in many parts of the country. After the housing bust during 2006-2008, lots of people were left with the inability to service their mortgages on high-costs homes, and new home buyers were having a hard time affording a new house due to the expense of high monthly payments. The Fed's suppression of long-term interest rates led US 10-year Treasury interest rates to an all-time, 220-year low in 2012, staying low through the early part of 2013. These low rates allowed current homeowners to refinance higher-interest mortgages, allowing them to have lower monthly payments and freeing up cash flow for other purchases (or for saving or debt reduction). New home buyers were able to afford larger or newer houses due to historically low interest rates, causing demand to surge for housing. This demand caused new home construction to revive during 2012-2013 as more buyers were able to afford new houses.

Now, with the "taper talk" having raised interest rates by around 1.2% (from 2013 lows), mortgage rates have gone up by a comparable amount, and affordability has gone down. In fact, after a final surge of purchases as rates headed up in May/June, mortgage applications have dropped significantly (with refinancings showing the largest drop). The following chart from The Calculated Risk blog on 8/21/2013 shows the extreme drop – back to a level not seen since early 2011.

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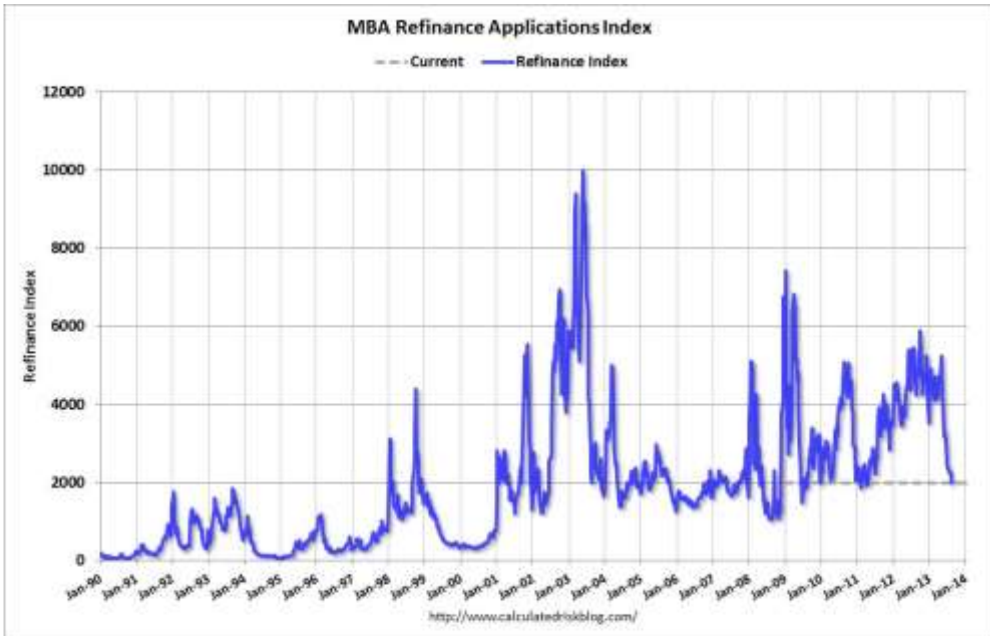

An improving housing sector impacts many facets of the US economy (construction, finance, furnishings, materials, and of course, small-business employment) so its downturn due to rates must concern the Fed. If the housing recovery continues to lose strength (housing prices either level off or fall and housing starts show progressively lower levels going forward), the Fed will have failed at helping the economy recover. Thus, we believe the Fed will try to re-establish its control or extreme influence over longer-term bond rates by keeping its bond buying constant or possibly even increasing the amounts. The urgency of taking action is illustrated by Wells Fargo, the largest mortgage institution in the US, which has just instituted **a third round of layoffs in its mortgage origination division in mid-September** (thousands of jobs in aggregate nationwide) which shows how much the mortgage/housing markets have already eased.

3. Equities – A large part of the Fed's strategy for helping the economy recover is using the "wealth effect" to its advantage. Thus, its monetary policy has had an objective of raising asset prices, which, theoretically, allows people to use this extra wealth to expand their businesses through either selling appreciated assets and redeploying the money to expand businesses or borrow against their expanded equity amounts. If tapering QE leads to falling asset prices, this wealth effect will be lessened or eliminated, taking away another channel the Fed is trying to use to direct stimulus more directly to the economy rather than just to banks to discretionarily deploy newly-created monetary resources. Continuing QE has led to multiple expansion (P/E ratios are up almost 20% from last year) that cannot continue ad infinitum; thus, continued QE may have less and less impact on stock prices but cause better inflation hedges to perform more strongly than equities in the future.

4. Foreign Markets – While the Fed is mostly involved in formulating and implementing policy for the US economy (with the US dollar being the world's reserve currency and world economies so interconnected), the Fed's moves have a huge influence on foreign economies, especially those with currencies pegged to the dollar. The Fed's suppression of interest rates since 2009 has had a profound effect on foreign economies as income investors moved capital overseas looking for higher yields. This movement of capital over the past 4+ years has given a number of economies a lot of "hot money" (foreign money that shows up suddenly looking for investments, but can also leave abruptly) that boosted these foreign economies but also brought inflation imported from the US; countries that experienced capital inflows include China, India, Brazil, Indonesia, Poland and many other smaller nations. When the Fed introduced "taper talk" starting in May and US rates rose (making them more attractive), hot money started flowing out of these economies and returning to the US. These reversed capital flows caused selling of foreign currencies and foreign bonds, causing the double whammy of lower currency prices (thus, causing imported goods, especially oil, to be more expensive – more inflation!) and lower bond prices (thus, spiking interest rates – recessionary forces!). Consequently, the Fed's "taper talk" has caused higher US interest rates and possibly some slowing forces on the US economy, but it has caused lower currency prices, lower bond prices, higher inflationary forces and recessionary forces in a number of foreign economies! Unfortunately, many of these countries have felt like they had to cushion some of these blows by using some of their reserves – some, like China (and to a lesser extent Japan), have sold US Treasuries in order to use these reserves to moderate some effects of higher US interest rates. To sum up, higher US rates have caused many foreign economies to suffer and have even caused some selling of US Treasuries, causing even higher rates. We believe this less visible result of "taper talk" will influence the Fed to move cautiously before removing any stimulus as foreign leaders yell and scream about their declining economies.

5. Banks – Although Fed policies over the past five years have had the desired effect of helping rebuild bank balance sheets, we believe there are still large amounts of problem assets on the money-center banks' balance sheets that are being slowly written-off and will take many more years to write-off completely. While large banks have made a lot of money by being able to borrow at roughly 0% interest rates and either earning risk-free profits with Fed deposits or lending at large spreads, we believe that banks making trading profits through buying bonds and selling them to the Fed is a strategy the Fed would like to continue to help banks continue this balance sheet repair.

6. US Treasury – While much longer-term, we also believe that the Fed does not want longer-term US bond rates to go higher because it will cause the cost of the US Treasury borrowings to climb during a time of "to-the-death" budget battles in Washington that will only be exacerbated by higher borrowing costs. With the Fed buying a majority of the US Treasury's issuance (through intermediaries – the Primary Dealer large banks), the Fed is already acting as a buyer of last resort for the Treasury, keeping rates low and borrowing costs low. But the rising amount of debt to be financed (in spite of the smaller deficit this year, each deficit, no matter how large, contributes to a growing amount of US Treasury debt) means that the lower the rates, the lower the overall borrowing costs. We have not seen this as a problem yet in the markets, but if rates were to continue to rise, the Treasury's borrowing costs could move higher much faster than market participants (and politicians) expect. The cost of Treasury borrowing will be a bigger problem in later years as the debt gets larger and larger. However, quickly rising borrowing costs could factor into the near-term budget battles in progress in Washington, and thereby add more angst to the bond markets and more impetus to the Fed to continue (or possibly increase) QE.

7. Fed "Academic Groupthink" – It appears that the more powerful members of the FOMC have convinced many of the Fed bank presidents of the need for quantitative easing as a way to achieve policy goals, most notably higher US employment. Chairman Bernanke, Vice Chairman (and new Fed Chairperson nominee) Janet Yellen and New York Fed President Bill Dudley have been the champions of the use of QE as increased monetary stimulus to lower effective interest rates, make businesses more profitable (especially the interest-sensitive sectors, headlined by the housing and mortgage businesses) and ultimately lead to higher levels of economic growth and a resultant reduction in unemployment. While some of these effects might be observed in the short run, multi-year bond buying is untested in peacetime and is causing misallocations of capital to higher-risk, less disciplined investments (that would not be funded in times of higher interest rates and resultant higher risks). Formerly independent thinkers around the Fed table now seem to be much more "toeing the line" with the dovish leadership, meaning QE is probably here to stay for a long time.

The first example of this trend is shown by the "change of heart" in Federal Reserve Bank President of Minneapolis, Dr. Narayana Kocherlakota. Formerly considered an interest rate "hawk" (tending toward higher interest rates, all else being equal), in 2013 his tone has become distinctly more dovish. Now, he appears to be firmly rooted in the "uber-dovish" camp: in a speech on September 26, 2013, Kocherlakota described how the Fed's monetary policy tools could work and his opinions on how he would like to see policy implemented, adding some of the most "easy money" comments we have ever heard from a US central banker:

> "The [Federal Open Market] Committee has to stick to its formulated approach—**<u>that is, it must do whatever it takes to achieve its communicated goal</u>**. In the early 1980s, doing whatever it took meant being willing to keep money tight, even though interest rates and the unemployment rate rose to unusual heights. By doing whatever it took to achieve its goal, despite these short-term costs, the FOMC was able to bring down inflation and inflation expectations.
>
> "Doing whatever it takes in the next few years will mean something different. It will mean that the FOMC is willing to continue to use the unconventional monetary policy tools that it has employed in the past few years. Indeed, **<u>it will mean that the FOMC is willing to use *any* of its congressionally authorized tools to achieve the goal of higher employment, no matter how unconventional those tools might be</u>**. Moreover, doing whatever it takes **<u>will mean keeping a historically unusual amount of monetary stimulus in place—and possibly providing more stimulus—even as:</u>**
>
> - **<u>Interest rates remain near historic lows.</u>**
> - **<u>Economic growth rises above historical averages.</u>**
> - **<u>Per capita employment begins to rise appreciably.</u>**
> - **<u>Asset prices rise to unusually high levels, leading to concerns about "bubbles."</u>**
> - **<u>The medium-term inflation outlook rises temporarily above 2 percent.</u>**
>
> "It may not be easy to stick to this path. But I anticipate that the benefits of doing so, in terms of employment gains, will be significant." **<u>[Emphasis ours – KS]</u>**

This seems unequivocally strongly-worded toward very easy policy for years to come. Dr. Kocherlakota has pretty much said that they will wait to taper or could increase stimulus until many indicators show many months of improvement. He has not been an official voter on FOMC decisions this year, **but he will become a voter for 2014, meaning his voice and his vote will count during FOMC meetings.**

Another example is Boston Fed President Eric Rosengren, considered a moderate on rate decisions and historically generally voting with the majority. He is a voter in 2013 (he won't be in 2014), and it would appear he would help the dovish camp maintain current bond-buying levels through the end of 2013 based on some of his comments from his October 2, 2013 speech:

> "If the economy evolves as expected [a slow improvement in employment and GDP from 2014 – 2016], **<u>policy should in my view include only a very slow removal of accommodation over the next several years – and that should only occur when the data ratify our forecast</u>** for an improvement in real GDP and employment." **<u>[Emphasis ours – KS]</u>**

Finally, there have been lots of speeches by members of the FOMC who are not as convinced about the future benefits of quantitative easing – Dallas Fed President Fisher and St. Louis Fed President Bullard come to mind – and yet, those who have voting power this year have not cast dissenting votes at FOMC meetings except for the newest FOMC participant, Kansas City Fed President Esther George, who has voted the only dissents lately. While Fisher is a non-voter this year, Bullard is a voter this year and has not dissented hawkishly, thus showing while there is dissent about decisions, voting members have not felt strongly enough about their opinions to vote against continuation of current policy.

<u>Alert:</u> just before press time, during the mid-October budget and debt ceiling battles in Washington, Bloomberg reported that even Dallas Fed President Fisher felt like the fiscal uncertainty around the US Government shutdown merited a "wait-and-see" attitude:

- **FISHER: FISCAL SHENANIGANS HAVE `SWAMPED' QE TAPER PROSPECTS**
- **FISHER: HARD TO NOW ARGUE TO CHANGE COURSE OF MONETARY POLICY**
- **FISHER HAS FAVORED TAPERING FED MONTHLY BOND PURCHASES**
- **U.S. FED'S FISHER REPEATS BEST TO 'STAY THE COURSE' ON BOND BUYING AT OCTOBER FOMC MEETING**

Looking forward, most Fed observers expect Janet Yellen to be even more dovish than current Chairman Bernanke. Commentator Peter Schiff of Euro Pacific Capital, via ZeroHedge.com submitted the following interesting perspective about Yellen:

> **"Now that Janet Yellen has been named to lead the Federal Reserve the global financial markets should factor out any possibility that the Fed will diminish their Quantitative Easing program anytime during her tenure.** In fact, financial forecasts should assume that

not only is a taper off the table, but that the QE program is now more likely to be perpetuated and expanded.

> **"Unlike her predecessors, Janet Yellen has never had a youthful dalliance with hawkish monetary ideas.** Before taking charge of the Fed both Alan Greenspan, and to a lesser extent Ben Bernanke, had advocated for the benefits of a strong currency and low inflation and had warned of the dangers of overly accommodative policy and unnecessary stimulus. (Both largely abandoned these ideals once they took the reins of power, but their urge to stimulate may have been restrained by a vestigial bias against the excesses of Keynesianism). **Janet Yellen, who has been on the liberal/dovish end of the monetary spectrum for her entire professional career, has no such baggage.** As a result, we can expect her to never waver in her belief that stimulus is the answer to every economic question."

As the Fed continues to stimulate, inflationary forces will continue to build, both in the US and world economies linked to US economic activity. Those forces will continue to spill out in expected and unexpected ways. Soaring asset markets like ultra-high-end real estate and contemporary art may go higher, but traditional inflation hedges like precious metals and commodities will appreciate explosively at some point in the future due to this unending stimulus – it's just a question of when.

The Managers of Kanos Capital Management