First Quarter 2015 Investor Letter

Portfolio Comments

The main story of the quarter was the actual implementation of European quantitative easing, which caused the euro to slide during the quarter and European stocks to rise (in euro terms). Otherwise, the focus was on the US economy, where strong employment reports in early February and early March caused the US dollar to further strengthen and both stocks and bonds to give up much of their quarterly returns. US stocks and Treasuries ended roughly flat by the end of March.

First Quarter Market Conditions

January continued the string of volatility that we saw in markets in the Fall/Winter of 2014. The best performing assets in January were silver (+9.8%) and gold (+8.7%). The MarketVectors Gold Mining Stock ETF (GDX) gained 20.56% during the month, snapping back from a poor December 2014 performance. In foreign stocks, European shares were big winners due to the depreciating euro; the German DAX index was up 9.1%, the French CAC 40 was up 7.8% and Spain's IBEX was 35 up 7.2%. Hong Kong's Hang Seng and Japan's Nikkei indices were the Asian winners, up 3.8% and 1.3%, respectively. Long-term Treasuries were the best bond market performers in January, rising 9.8% (as represented by the TLT ETF) although US corporates and mortgage bonds also did well. The US dollar was very strong, rising against the euro (+7.2%) as the European Central Bank (ECB) unveiled its plan in mid-January to start quantitative easing. The S&P 500 was down 3.0% for the month, led lower by the Financials, Energy and Technology sectors. The Utilities and Healthcare sectors bucked the trend and were up for the month. The main losers were weaker European country stock markets (Greece/Spain), economically sensitive commodities (copper, grains, oil, etc.) and European corporate bonds (although most European sovereign bonds were stronger, but still ended lower for the month).

In February, many of the assets that underperformed in January snapped back, while outperformers generally gave back gains. The S&P 500 rose 5.75% for the month (total return), moving back into positive territory for the year with the Technology, Consumer Discretionary, Materials and Telecom sectors moving up strongly. Laggards were the Utilities and Energy sectors. In international markets, European markets were all up high-single digits for the month, led by Italy, Spain, Germany and France, with even Greece and Russia rallying strongly. Bonds had a horrible month, giving back all of January gains and more – the long Treasury bond lost almost 12%. As risk returned, US corporates

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and mortgage bonds were mostly flat for the month and high-yield bonds were up 2%. Oil rebounded from an awful January, with WTI gaining almost 4% while Brent gained more than 10% (due to Libyan and Iraqi supply disruptions). Gold and silver gave back some of their January gains, with gold down 5% and silver down nearly 4%. The dollar gained against the yen, but the euro was flat.

March was a poor month for most financial assets except equities in Asia and Europe. The Chinese stock market was the stand-out in March, with the Shanghai index rising 13% to lead all indices. The German DAX led European equities with a 5% return, while Japanese, Italian and Spanish indices gained between 3-4%. The biggest losers were commodities and commodity based countries and currencies. Brent crude was down more than 10%, and WTI was down almost 5%. Russian and Brazilian stock indices led the majority of emerging market stock indices lower. Corn, wheat and gold were down a couple of percent for the month, but silver was up a fraction. The S&P 500 was down 1.58% for the month with a rising Healthcare sector the only winner during the month. The Materials, Technology and Utilities sectors were the worst performers in March. Treasury bonds and European government bonds gained fractionally during the month, but emerging market bonds and US high-yield bonds were losers, led lower by Energy bonds. The dollar again gained versus the yen and euro.

Equities

For the quarter, the S&P 500 returned just 0.95% (the Dow Jones Industrial Average was down for the quarter), ending at 2067.89. As mentioned above, the S&P had negative returns in January and March, but was bailed out by a very strong February as worldwide monetary easing and moderating (but 'not-too-negative") earnings announcements encouraged investors to continue to buy stocks. During the quarter, the Healthcare and Consumer Discretionary sectors (led by Apple) handily outperformed, returning 6.53% and 4.80%, respectively. Sectors that were lower during the quarter were Utilities (off more than 6%), Energy (off almost 3%) and Financials (down more than 2%). Interestingly, the rampant bullishness of much of the investment community was not really dimmed by the relatively poor performance of the equity markets during the quarter.

In worldwide equities, there were a number of big winners. European stocks led the charge, with German stocks returning 22% for the quarter. Some other European stock indices did even better, with Denmark (+27.3%), Italy (22.8%), Portugal (21.6%), the Netherlands (19.7%) and France (17.8%) shooting higher with the January introduction of European QE (and the concomitant drop in the euro). Asian equities were the other big winners, with the Shanghai index up 15.9% for the quarter, the Japanese Nikkei up 10.1% and India up 5.5%. Other stock markets that moved up strongly due to their currencies falling were: Ukraine (+57.3%, but up only 6.1% in US dollar terms), Sweden +15.1% but up only 4.4% in US dollar terms) and Spain (+11.8% but down 0.7% in US dollar terms). Losers were European peripheral countries, Brazil (due to lower oil, bribery scandal, poor governance) and Middle Eastern stock markets (due to ratcheting up of military action and tensions in the area).

Precious Metals

Gold and silver rallied during much of January, but the introduction of quantitative easing in Europe led buyers to shun metals and buy more stocks during late January and February. Large employment gains in the US caused investors to speculate that the US Federal Reserve (the Fed) would raise interest rates as early as June 2015, leading investors to sell precious metals and redeploy capital into momentum-fueled growth stocks. However, when gold and silver tested their multi-year lows in mid-March, those lows held easily, and the metals moved higher for the rest of the month, with gold ending at $1,183.10/oz. Gold stocks, generally considered a “tell” on the direction of gold and silver, bottomed earlier in March and moved higher for most of the rest of the month. Gold returned about 0.01% for the quarter, after rising strongly in January and giving it back over the rest of the quarter. Silver performed better, gaining over 5% for the quarter, holding more of its January gains than gold. Gold mining stocks, best represented by the ETF GDX, were roughly flat. North American miners performed better on average than South Africans (which we do not own), the other large group represented in the ETF.

Energy

Energy was again one of the main focuses of the financial markets during the quarter. Crude oil prices rebounded from their late 2014 lows, and rallied slightly during January and February. However, filling US storage, the specter of Iran’s return to full participation in the oil markets (if a deal is reached with the US and Europeans) and rising US production combined to drive oil prices to new lows in early March (helped along by a still-strong US dollar), although prices then rebounded slightly at the end of March, with WTI ending at $47.60/bbl. Brent lost about 5% for the quarter, while WTI lost closer to 10%. As noted above, energy equities in the S&P 500 performed better than crude (down less than 3%) as investors saw bargains in beaten-down quality exploration and production companies. However, low prices took their toll on balance sheets, as companies saw “lower for longer” as a reason to come to the capital markets and bid for capital; many debt and equity deal were done during the quarter (much to our surprise, but at very low prices – the dilution to current owners was severe in many cases). The strength of the major oil companies and pipeline MLPs underpinned the averages – they performed well, keeping oil equities from looking worse.

Bonds

Longer-term Treasuries were very strong in January, but gave back much of those gains during February and March after strong employment reports in both of those months gave investors the idea that short-term interest rates could rise sooner than many anticipated. The 10-year Treasury ended the quarter at 1.93%. European sovereign bonds did much better, buoyed by the European Central Bank’s (ECB) announcement of QE in mid-January and implementation in early March. Spanish bonds returned more than 6% for the quarter, against an end-of-quarter yield-to-maturity of 1.21%, showing appreciation (and surprisingly little yield [for the risk!]). Corporates mirrored Treasuries, although

they performed better in March. US high yield bonds rose for most of the quarter, although they lost some of their January and February gains in March.

Other Markets

In other markets, the US dollar was again the big story, mostly against the euro. The US dollar was up approximately 10% for the quarter, after reaching just above 100 (up more than 12%) on the US Dollar Index in mid-March. The euro was down the reciprocal ~12% against the US dollar through mid-March, but rallied back into the end of the month. The British pound was roughly flat versus the US dollar through February, but had a horrible March (down 5%) as UK economic statistics sputtered. The Japanese yen was roughly flat against the dollar for the quarter.

Going Forward

A growing number of investment managers have been issuing warnings about the valuations in the markets, the historically large influence of central banks on financial markets and potential implications of these elements and their combination. Howard Marks, President of Oaktree Capital Management (who manages around $90 billion and concentrates on the debt and distressed debt markets), wrote a recent letter about how markets appear to be expecting greater liquidity from ETFs than from their underlying assets – a set-up which is unsustainable for anything more than a short time. However, we were most impressed with what he says investors should do when faced with market illiquidity (and consequent turmoil); he is a firm believer in preparation, and he sums up his mission, which I believe is the same as our mission. He states if very well:

- Buy assets, hopefully at prices below intrinsic values, that can be held for a long time … even if prices fall or price discovery ceases to take place; and
- Make sure that investment vehicle structures, leverage arrangements (if any), manager/client relationships and performance expectations will permit a long-term approach to investing.

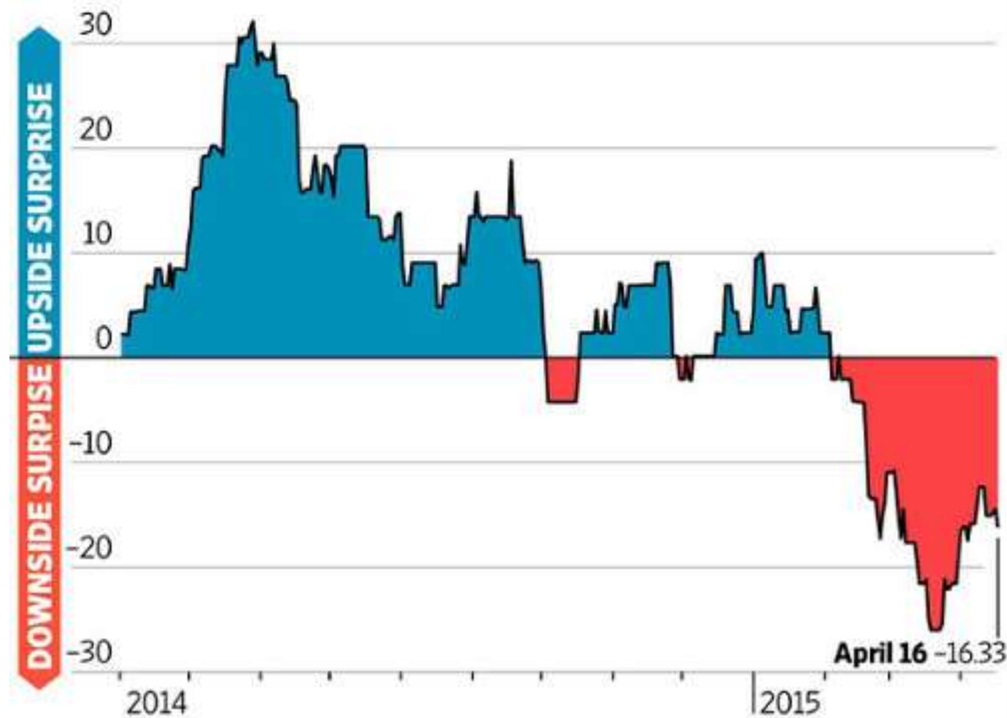
We, like Oaktree, try to follow these principles which we believe over time will lead to wealth creation.

Economy

The US economy, long touted as the engine of world economic strength and the only place for steady growth (China is generally considered to have falling growth), experienced a poor first quarter, masked by good job reports in early February and March. Factory orders and consumer spending, two key elements in growing production and consumption, have fallen for three straight months. In addition, Institute of Supply Management (ISM) reports, which show "flash" reports about the manufacturing and non-manufacturing/services parts of the US economy, have shown weak results,

confirming a softening of economic activity. Also, the regional Fed surveys (from Philadelphia, Kansas City, Dallas, Richmond, New York, etc.) have all shown disappointing results, with the latest Dallas report starting to show the carnage of falling activity in the oil sector.

The Wall Street Journal, in a mid-April article, showed graphically (actually sourced from Bank of America/Merrill Lynch) how the US economy has decelerated lately as measured by misses on forecast expectations of economic growth. The graph below shows in stark terms the deterioration of results.



The Fed, elected officials and the press pay a lot of attention to employment reports. However, many market economists consider employment to be a "lagging indicator" (people continue to hire even if there is a lull in company activity during growth phases, not wanting to lose market share if the economy continues to grow); thus, good job reports are not a great indicator of how the economy is doing presently, but are obviously a big political "hot button". With poor economic results for 2015 so far, and very disappointing April jobs report recently released, we may be seeing a confirmation of a true slowdown in US economic activity, which could be a precursor to recession. Certainly, it means

the Fed will continue to lean more "dovishly", holding off on any tightening measures and possibly preparing the markets for further stimulus if they judge the economy is not in just a temporary lull.

Equities

Equities worldwide moderated their gains in March, but appear to have re-accelerated in April as new highs have been registered in many markets around the world. The US S&P 500 and Nasdaq have hit new all-time highs in late April, as has the German DAX index. In addition, both the Japanese Nikkei and Chinese Shanghai indices have hit multi-year highs during this same period. We believe this action shows the strength of new (2014/15) monetary easing initiatives from the EU, China and Japan, which then spills out to many other world markets (the US). However, the sputtering of US and Canadian (and possibly Chinese) economies, along with the near recessionary conditions of some of the weaker European economies (think France and Italy), continues to highlight the question of efficacy of QE.

However, the net effect of two strong forces continues to push up equity prices: rising global liquidity and the strong dollar and its effect on US companies. Taking the latter first, we believe the strong dollar (which strengthened most appreciably in the last few months) will continue to hurt the sales of US domiciled companies (which must convert financial results to dollar equivalents); we have started to see it in first quarter earnings reports which are currently being released. Revenue misses are frequent in large companies, most of which have large overseas operations. We believe headwinds from overseas competitors' sales (who can underprice US companies due to weaker euro or yen vis-à-vis the US dollar) will continue to hurt revenue growth. Meanwhile, costs pressures from labor and raw materials might actually start to impact results in the future – these have been depressed in the past few quarters, helping corporate profit margins stay high.

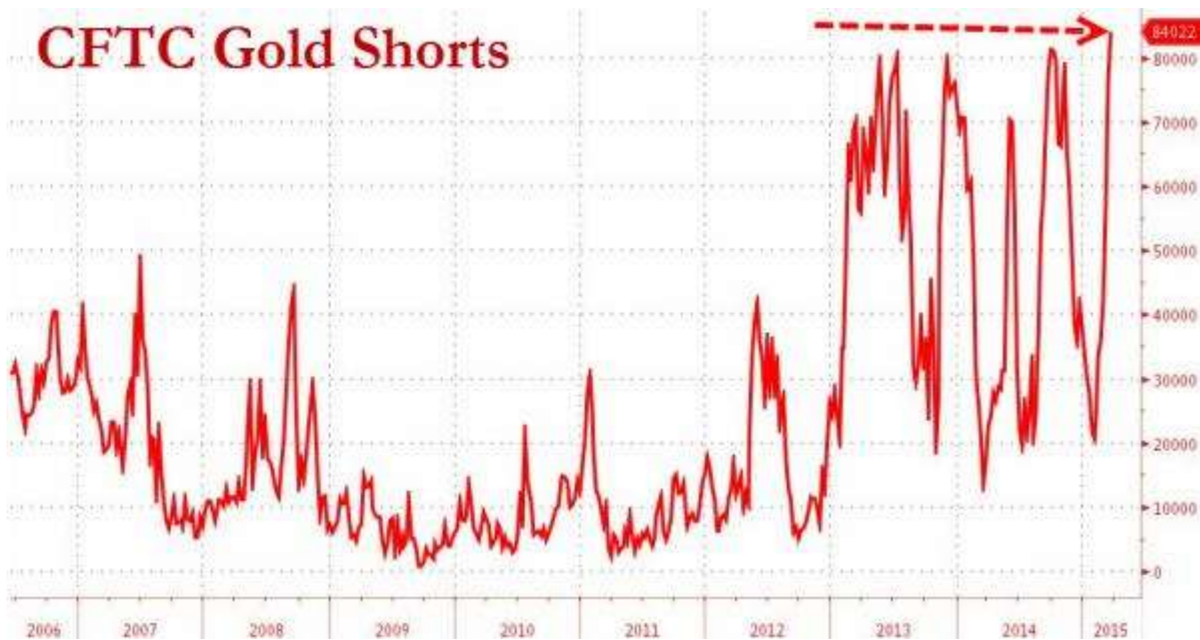
Counterbalancing the strong dollar is the large amount of monetary stimulus emanating from central banks and governments around the world. European quantitative easing has had a surprisingly smooth reception, pushing down the euro and giving European exporters a lot of confidence to be able to grow worldwide market share with much more competitive pricing. China, on April 19th, cut its bank reserve ratio by 1% (meaning banks can lend out 1% more of their capital base, which many analysts estimate could be more than $1 trillion yuan), freeing up economic liquidity and leading to a resumption of the rally in Chinese stocks which began late last summer. In addition, the Bank of Japan affirmed their easing programs, and the Fed seems to be on hold for raising rates with the latest poor economic reports. **We believe this continued "firehouse" of high-powered money will continue to buoy world stock markets, including the US markets, in spite of strong dollar effects on earnings and economic deceleration in some of the larger economies worldwide.** With new highs being set, we believe large pools of capital will continue to rotate to equities instead of low-yielding (and in many cases low-grade) debt securities. Central bank debt-buying programs will continue to drive yield-starved investors to riskier equity exposure for better yields and continued belief in further appreciation. Thus, we have invested in European and Japanese equities (with currencies hedged) to take advantage of the uplift in share prices that QE has driven in the past. In addition, we are adding selectively to our US stock exposures in sectors that are attractive during this

phase of the markets. Finally, we may be hedging our portfolios for upside exposure by adding index ETFs if conditions dictate. However, we are apprehensive about how the markets may resolve themselves in the longer term (possibly as early as late summer/autumn); for now, we see equity markets advancing during the late spring/summer.

Precious Metals

As noted above, precious metals weakened during much of February and March as employment gains drove market expectations of Fed rate hikes by mid-year 2015. However, after these two strong jobs reports, the Fed met and came out with a very "dovish" statement, giving many reasons why they would be very patient to see that outperformance of the US economy before raising rates or changing monetary policy. We believe that a continued dovish Fed, combined with growing inflation pressures, will buoy precious metals prices, and as inflation becomes a concern, metals prices will rise. There are also a number of other factors that point toward higher metals prices this year:

"Large speculators", as designated and shown in weekly government [CFTC] reports, built a very large short position (they are generally hedge funds and commodity trading funds, many of which are momentum players) as prices fell in February/March. As of late March, they had reached the largest short position in gold in years (see the ZeroHedge chart below published on 4/3/2015):



Each of the other times short positions have reached this extreme (in the table, in mid- and late-2013, and mid- and late-2014), precious metals have rallied strongly. On the other hand, the CFTC reports show Commercial Hedgers (the banking and other companies that trade the most in physical metals and hedges) **have their smallest short position in years** (they are naturally short, buying physical metal and shorting futures contracts against their physical positions to stay hedged). They are

considered the best "operators" in the markets, with the ability to gauge what buyers, sellers and futures traders are doing in markets due to their operations. When they have only a partial short position in their hedge books, this means they are net long and expect prices to rise in the near future. **We believe that this situation should lead to a gold rally, and with the building wave of liquidity (24 central banks have lowered rates or instituted quantitative easing in 2015 alone) driving up money supply, we believe that this rally could lead to the resumption of a bull market in precious metals.**

In addition, industry research newsletter, The Gold Stock Analyst, estimates that precious metals mining stocks are 46% below their post-financial crisis average valuations, showing their extreme undervaluation. We feel our continued focus on this sector will produce outsized gains, especially during a time when the US stock markets have slowed some of their upside momentum, and valuation issues in US indices point toward future outperformance of out-of-favor sectors like miners.

Energy

The energy world remains an enigma, with huge crosscurrents obscuring the future direction of oil prices. There are questions on both the supply and demand sides, so we will explore both sides of the equation to try to reach a conclusion on future price moves.

Demand is typically the short-term driver of price moves. Slowing economic growth as expressed by decelerating economic statistics in both the US and China (as well as the continued moribund economic results out of Europe) seems to indicate that there will be continued pressure on prices. Oil exporting countries, especially those in the Middle East but also including Russia, Brazil and African exporters, also have decelerating economies due to much lower oil revenues. In the past, much lower prices have served to promote growth in demand, and lower oil prices have been a boon to industries in big energy consumers like India, Japan and Western Europe, as well as the East Asian emerging countries. Thus, while many economies suffer from the budding recession in the oil industry, energy-dependent countries are the beneficiaries and appear to be boosting demand. At least a couple of notable energy analysts (as well as at least a couple of prominent hedge fund managers) believe supply and demand are in a much more delicate balance than prices have signaled, and oil prices could surprise to the upside going forward.

On the supply side, suppliers used to very high prices for the last few years appear to be using all their capabilities to produce "flat out" to try to maintain cash flows as high as possible. This points toward continued high daily supply which could swamp demand in the next few months. While prices of WTI fell below $60 in December 2014, daily production has continued to climb for months, although production may be plateauing now in late April. Financial reports differ, but a number of US shale oil producers say that they can make money with WTI prices in the $50s range – if this is true in scale, those US producers who can make money at those prices will keep the US market well-supplied and prices low. The Obama Administration has announced a "framework for an agreement" with Iran over its nuclear program that, if adhered to, will lead to higher Iranian production later in 2015. Libya, in an almost constant civil war among tribes, appears to be able to produce up to 1 million

bbls/day if hostilities don't curtail exports as has happened much of the time over the past three years; but with prices down, we believe tribes will be incentivized to try to produce on the high side to continue to finance their consumption and arms purchases. Finally, Saudi Arabia, while having raised prices slightly to Asian customers for the past two months, continues to insist it wants to at least maintain its market share, and it has backed it up by producing an estimated 10.3 million bbls/day in April, which is very near an all-time high. OPEC as a whole also produced at the highest rate since 2012, 30.7 million bbls/day, with Libya at only 480,000 bbls/day.

We continue to look at the shape of the forward price curve, which continues to be in contango (later prices higher than current prices) which indicates relative price/demand weakness because crude for immediate delivery is selling at a discount to future supplies. [The alternative to contango, backwardation, is when current prices are above future prices, indicating high demand is "bidding" for all current supplies and trying to buy oil out of storage]. The oil market was in strong backwardation for years through early 2014 but switched to contango in later 2014 and has maintained that contango through April 2015. **We believe the contango points to continued lower prices – especially as US storage is at all-time records and very near "absolutely full," meaning that once storage is full, price will ration the amount of production going forward. We believe the indications of continued contango, along with the desperate need for cash flow from sovereign producers as well as stressed US shale producers, will push producers toward maximum production, keeping a lid on oil prices for at least the remainder of 2015.**

In natural gas, the continued push toward maximum oil production (which in many cases produces associated natural gas), coupled with a mild spring (meaning lower gas demand for heating), will keep a lid on depressed US natgas prices, in spite of continued increases in gas-fired power production in the US (at the expense of coal-fired plants). We think US shale oil companies, burdened by the loss of cash flow from higher oil prices, will keep oil production high, which will lead to continued gains in gas production as a byproduct of oil production, keeping supplies high and prices low. Prices have been below $3/MMBtu for almost all of 2015, and absent a very hot summer, we see prices staying at these levels (or lower) at least into the winter months.

Bonds

As bond yields and depressed currencies hit new lows at the end of January, pundits suggested that far lower levels for both would happen during the spring of 2015. After some overdue bounces in yields and currency levels in the last few weeks, a number of analysts have changed to projecting higher interest rates in the near future, which would boost the depressed euro and send the dollar lower.

Stepping back and examining the whole picture, we believe this is premature. With the ECB in full quantitative easing mode, most European bond rates are very low and could stay low as ECB purchases continue through next fall. Punk economic results in the US and China point toward economic weakness in the future in the top two economies in the world, which would argue for lower rates, not higher rates. Furthermore, the tone of easing has changed in both countries, with the Bank of China providing more liquidity and Chinese bank regulators easing bank reserve requirements

twice in the past few months, the equivalent of large interest rate cuts. The Fed has also moderated its perceived march toward a June rate increase, indicating that a June boost is virtually off the table and a September increase is the first (and possibly only) time that they would raise rates, a much more dovish stance than just a month ago.

Thus, the continued worldwide dovishness of central banks, coupled with the sputtering economies of the developed world and China, seems to point toward lower rates for longer-dated bonds, and perhaps much lower, if there is financial upset in stock markets or the economy decelerates further, threatening recession. We will maintain our holdings in Treasury bond ETFs and will selectively look at interesting bonds situations as worldwide quantitative easing and economic malaise show the way to low bond yields during the summer.

Other Markets

The currency markets have eased off "center stage" in the past couple of weeks. The Japanese yen has traded in a 117-120 yen/$ band and the euro oscillates between 1.05 and 1.10/$. Both these levels appear to be consolidation points (where the extreme oversold levels have been corrected) and some of the speculative fervor of a "can't miss" investment position fades. We believe the "shot in the arm" economic improvements of the BOJ and ECB provided through their QE policies will lead their leaders to continue to pursue them. Meanwhile, the higher rates of stronger currencies like the US dollar and Chinese yuan will continue to lure capital on the margin toward higher yields, continuing pressure on the yen and euro. Once the yen breaks 120-121/$ definitively, many currency analysts see it moving to the 140-150/$ range next. In the same vein, if the euro drops below the 1.04-1.05/$ level, many believe it could reach as low as 0.80-0.85/$, the levels last seen after both the US and Europe had a recession prior to the Great Recession of 2008-9. Currently, the euro has caught a bid and moved higher out of its 1.05-1.10/$ range, catching some speculators off-guard, but we believe this is further correction of a large oversold condition, and that the downtrend in the euro will reassert itself later in the spring/summer. **We continue to maintain short yen and short euro positions via ETFs and expect these positions to continue to appreciate as further QE pushes down currency values but adds only fleeting progress to Japanese and European economic growth.**

Kanos Quarterly Commentary

Psychology – The Wildcard But Not the Final Word in Finance

When I was a child, I remember "knowing" that Rembrandt was a very important painter. Seeing a real Rembrandt (I believe it was in the Museum of Fine Arts in Houston) was a real thrill – I was actually standing next to a truly unattainable thing. Whenever I see a Rembrandt, I am still amazed.

But I am pretty sure none of my kids or their friends even know who Rembrandt is. And I would be willing to bet that there are a huge number of adults that consider him just another painter. Art collectors apparently feel the same way: a recent painting which hadn't been seen in 40 years sold for a relatively modest price of $33 million (for a 350 year old masterpiece). Meanwhile, art by either living artists or modern artists is being sold for far more extraordinary amounts. For example, in 2005, hedge fund billionaire Steve Cohen paid $12 million for an embalmed 15-foot Tiger Shark in a glass tank by artist Damien Hirst, a 40-year-old darling of contemporary English art. And Jackson Pollock's drip painting *No. 5, 1948* sold for $140 million in 2006, a record for an American painting.

The point of these observations is that psychology plays a big part in valuing objects, especially art objects, but psychology also extends to valuation of financial objects, like stocks and bonds. While far more homogenous than works of fine art, companies are all unique, as are investing eras. An investment manager must pay a certain amount of attention to psychology and how it affects values at any given time to make better investment decisions.

Momentum investors and short-term traders have to be the most sensitive about psychology because many of the stocks (and other financial assets) they own are based on psychology. More specifically, investors' high valuation of these stocks is sometimes due to perceived attractiveness.

As value investors, our job entails trying to work our way through investor psychology to better determine whether low-valuation investments (or those stocks, bonds, commodities, etc. that have had either higher nominal prices or higher sales prices compared to production costs) are merely out-of-favor with investors (and thus represent investment bargains) or are suffering cyclical or secular declines. On the flip side, we are also charged with deciding if highly-valued companies and investments are worth the premiums due to high perceived growth or new products or processes.

Generally, investment psychology is cyclical because certain psychologies run to extremes before they reverse and revert toward the opposite. What makes investing especially difficult is that these cycles generally last for many years. However, studies performed over many years and investment climates have proven that value investing leads to higher overall returns than growth investing.

Since the advent of the most recent episode of quantitative easing in the United States (from 2011 to present), investor psychology has greatly favored growth stocks, as investors became concerned about US economic growth in general but felt the Fed was interested in higher stock prices to generate a wealth effect. So many investors piled into growth stocks, and index funds and momentum investors followed, sending growth stocks higher as leaders during the current bull market. Many in markets believe that the large increase in computer trading has also exacerbated moves in the market, making winners go up more than in prior periods and punishing out-of-favor stocks more than in prior eras.

So, as investment managers, how do we see the present environment and how do we see psychology impacting markets going forward? We think three main elements are most important but there are three cautionary points also:

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1) **Rising Equity Markets** – The extremely easy monetary policy that dominates the global macro-environment is being pursued to push asset prices higher, led by financial investments like stocks. The US recovery from the financial crisis of 2007-2009 was jumpstarted by quantitative easing from the Fed, leading the US to have the first and strongest economic recovery. Enough money from the Fed found its way into the financial markets to push stock and bonds prices higher, an advance that continues today. Japan "doubled down" on their efforts at jumpstarting inflation and Japanese economy through the implementation of Abenomics (starting in late 2012), which has led to a long-lasting rally in their stock market (after the yen declined significantly). The notable G-7 laggard, Europe, has been seemingly forced by these episodes to adopt the same strategy: in order to revive economic growth and inflation, the ECB has implemented a massive quantitative easing episode that has successfully driven down the euro and led to a nice stock market rally in late 2014 and early 2015. Finally, China's slowing economy caused Chinese regulators to pursue more monetary easing, leading to higher Chinese equity prices. Thus, psychology in worldwide equity markets has been conditioned to expect higher equity prices as monetary easing is fed into world financial/banking systems. With quantitative easing in force throughout most of the developed world, and most thinking that any upset in US equity markets would cause the Fed to pursue "QE4", psychology is arguably a main determinant in investors' bullishness toward worldwide equities, in many cases in light of near-historically high valuations.

2) **US Growth and Strong US Dollar** – With Japan and Europe actively adding reserves to their financial systems (thus driving down the value of their currencies), foreign investment managers, looking at preserving the currency-adjusted value of their investments, have been moving their investments to the US where the strong dollar adds a "tailwind" to their investment returns. This movement of capital thus favors US investments, both stocks and bonds (which have a higher yield than similar duration European or Japanese bonds, reflecting greater US growth expectations). The psychological effect of US economic growth (even if slow) and US dollar strength (due to QE in other developed economies) has led to more capital migration, with capital moving into US equities pushing up a number of growth and momentum stocks to levels not seen the last century. We believe this will continue until QE is stopped in Europe.

3) **Continued Easing Until Growth or Inflation is Achieved** – Easing has characterized Fed actions since Alan Greenspan's tenure as Fed Chairman began in 1987. The psychology that the Fed will ease at any sign of trouble appears to be fully ingrained in the US (and world) financial system. The failure of US fiscal policy in recent years has led to little fiscal reform and resulted in continued deficits and growing national debt and entitlement liabilities to be financed by government debt. Public and private debt must not become burden on the US economy while the Fed attempts to reignite higher growth seen pre-financial crisis. And the Fed has said that part of its plan for growth is at least two percent inflation. Thus, the need for low interest rates (to support all the debt and to foster accelerating economic growth) and the fostering of inflation (to signal growth to consumer and raise asset prices, leading to a wealth effect) has become the overarching psychology of financial markets. This psychology has also reinforced the notion of a "Fed put option" for equity prices, meaning the Fed would ease monetary policy if US stock prices drop significantly. Until inflation heats up too much or political reasons block the Fed from acting, this expectation of easing should lead to higher nominal prices for assets, regardless of

valuation, for equities, real estate and other tangible assets. In addition, since the "US model" rescued the US financial system post-2008 and the US has shown the most growth in the developed world, the Europeans, Japanese and increasingly the Chinese are adopting the "Fed blueprint", which should lead to higher asset prices worldwide, until inflation and malinvestment leads to the end of the boom.

But remember Rembrandt? Psychology changes as situations change. And we believe that the world of endless monetary easing is not sustainable – eventually, the downside of easing – too-high valuations leading to sell-offs and inflation – will reappear. Thus, we have to understand current markets but be ready for change when psychology changes. Psychology will almost certainly change when investment managers no longer think they can make money in the markets, or put another way, when they believe easy money policies start to hurt rather than help their investments.

What could cause a change? We think there are at least a couple of things:

1) Economic Stagnation – current economic conditions are starting to point toward a petering out of this economic expansion. As US corporate results for the first quarter of 2015 are being reported, a large amount of companies are missing expectations for revenue growth (so far, the count appears to be over 50% revenue misses) although earnings per share results have been much closer to expectations due to share buybacks and financial maneuvering of tax rates, etc. In addition, S&P 500 earnings are expected to be down year-on-year for the next couple of quarters for the first time in many years, due mainly to the higher US dollar and much lower energy company earnings. This sputtering of top-line and bottom-line growth will most likely lead to a "re-rating" [polite-company term for a large stock market decline] of high stock valuations if investor psychology turns and people get nervous about preserving prior gains.

2) Higher Measured Inflation – if inflation really does start to register with higher labor costs (and a higher dollar as calls to increase US rates would rise), corporate profits could show a downward bias and cause investors to sell overvalued stocks. In addition, higher perceived inflation would cause holders of long-term bonds to want to hold fewer of them, causing a bond market slump and higher interest rates, which would depress the economy and lower asset valuations.

3) End of Complacency/Exogenous Shock – the financial markets have gotten used to favorable conditions from corporate profitability (low wages and interest rates, plentiful capital), central bank policy (zero rates, multiple QE episodes), beneficial currency movements (low dollar to restart growth, rising dollar to attract investments). However, high multiples and optimistic earnings forecasts have propelled valuations to nearly record levels, and investors continue to invest at these very high valuations. If this complacency is upset, markets could react to the downside. An exogenous shock (like a large earthquake in California, a terrorist attack on the East Coast, etc.) could cause people to quickly readjust their profitability thoughts, leading to a market panic – we did see one just fourteen years ago with the 9/11 attacks.

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4) Central Bank Moves Fail – the final and easiest prediction of what could cause a change in psychology is the failure of markets to react to Fed moves the same as in the past. An example would be if the Fed saw the need to introduce "QE4", a new round of quantitative easing (due to recessionary conditions emerging in the US or the stock market falling), and in spite of bond-buying under QE4, long-term Treasury rates rose and the stock market continued to fall. If Fed policy trying to steer markets failed to do so, and markets continued to move the opposite way (which could happen due to nervousness of large investors who take days/weeks to be able to sell out of large positions), then almost certainly investor sentiment/psychology would change.

As stewards of your capital, we continue to try to participate in current markets, but on a risk-adjusted basis, buying and holding attractively-valued stocks and bonds, favorable currency and natural resource investments and hedges to protect your portfolios against sharp movements that could appear unexpectedly. Our value investments have not fared as well in the environment of unfettered optimism shown by many technology, biotech and consumer discretionary companies' stock prices. However, we believe history is still a very good guide for long-term investing, and history tells us through a number of studies over the last few decades that value stock investing beats growth stock investing results. We continue to position portfolios to participate in market advances but be the beneficiaries of any shift back toward more historical financial valuations.

The Managers of Kanos Capital Management
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