KANOS
CAPITAL MANAGEMENT, LLC

Third Quarter 2016 Investor Letter

Portfolio Comments

Our portfolios were volatile during the quarter as central bank decisions, oil market gyrations and the changing US political climate drove investors to switch back and forth between risk positions and defensive positions. Our portfolios' diversified and slightly defensive posture helped us to outperform in July but underperform in August, with September roughly flat. Our US stock portfolio performed well with our industrial, retail and healthcare stocks performing best. Our Treasury positions sold off during the middle of the quarter but again proved their worth in late September as market turbulence buffeted stocks but our bonds gained back virtually all their mid-month losses. Our precious metals positions had a great July but corrected during August and September, even though they are still having the best performance in more than five years.

Third Quarter Market Conditions

The third quarter was volatile after the surprise Brexit referendum results. Continued but weak economic growth worldwide and continued dovish monetary policy put a bid under stocks, as shown by the S&P 500's quarterly gain of 3.85% (dividends included), taking the S&P's gain for the year to 7.84%. Risk was back in vogue for investors, who drove technology stocks to new all-time highs during August. Besides technology, Financial, Consumer Discretionary and Energy stocks were sector gainers, while the winners of earlier in the year, Utilities, Telecom and Consumer Staples, gave back some of their gains during the quarter.

July continued the late June rebound in equity prices worldwide, with US large-cap stocks hitting all-time records during the month. The S&P 500 was up 3.69% (dividends reinvested) during July, hitting new highs and settling near those highs at 2173.60 (the Nasdaq was up the most in the US: +6.6% during July). The Technology, Materials and Healthcare sectors showed strong price appreciation during the month, while the Energy, Consumer Staples and Utilities sectors were lower. International equities also showed strength, rebounding after the reaction to the Brexit vote drove prices lower in late June: Brazil's Bovespa (+11%), Germany's DAX (+7%), Japan's Nikkei (+6%) and Hong Kong's Hang Seng (+5%) paced markets higher. Most countries' markets were higher, as was the beaten up European banking sector (+6%). Bonds were generally higher during the month despite their high levels at the end of June in the shadow of Brexit: all "flavors" of US bonds (government, corporate, high-yield, municipal) indices were higher, although Treasuries were just fractionally higher in price (lower in yield) with the 10-year at 1.458%. Gold and silver had a good month with silver rising another 9% and gold up over 2% during July. Gold closed at $1,349.00/oz

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and silver at $20.312. The big losers for the month were crude oil and grains: West Texas Intermediate crude oil (WTI) dropped almost 18% (Brent crude was down -17%), and corn and wheat were down almost 10%. Crude lost ground due to building inventories and a perceived weak summer driving season; grains were down due to good growing weather and huge crop yields. The US dollar was slightly lower for the month, mostly against the Japanese yen but also against the euro.

August was a different story in many markets due in large part to the strength in the US dollar. The S&P 500 was roughly flat for the month, rising just 0.14%, including dividends. Sectors that led the way were Financials, Technology and Energy. Utilities, Telecom and Healthcare were laggards, dropping during the month. Overseas, many indices showed gains: the German DAX, the Japanese Nikkei and other Asian indices rose in price as their underlying currencies showed weakness against the surging dollar. In general, the Emerging Markets were stronger due to currency moves. Treasury bonds ended the month virtually unchanged, while corporates and high-yield gained slightly. Precious metals gave back some of their recent gains after a strong early August jobs report dovetailed with more "hawkish" Federal Reserve officials' rhetoric to cause a correction. Metals miners, the stars of the year so far, retrenched, as late-to-the-party investors bailed out as momentum became too stretched. WTI Crude oil rebounded from an early month low on the back of supply disruptions to push to nearly $50/barrel before falling back on demand concerns, closing at $44.75/bbl. Agricultural commodities were again big losers during the month, as almost perfect weather drove US crop yields to 20+ year highs. Finally, as mentioned above, currencies almost universally dropped against the dollar, with the yen dropping the most (-0.92%) while the euro dropped -0.40% and the Mexican peso was roughly flat.

September ended up being a less volatile month than many predicted, although there was still plenty of movement around the Fed meeting (where they held rates steady once again). In the oil market, rumors of a production ceiling simmered all month, culminating in a potential agreement by producers meeting in Algiers late in the month. The back-and-forth action of many markets also characterized the S&P 500, which closed with a tiny 0.02% gain for the month. The Technology, Energy and Utility sectors were the only gainers for the month, while Financials, Consumer Staples and Real Estate sectors led the losers. Bonds were unchanged-to-higher despite a mid-month swoon as the bond-market anticipated a rate hike which didn't come. High yield bonds gained slightly for the quarter while investment grade bonds and long-term Treasury bonds were slightly lower. Precious metals were higher after their August drop, although mining stocks were only slightly higher for the month. The biggest winners were beaten-down commodities, with corn and wheat up almost 12%, and the CRB commodity index up nearly 4% for the month. One loser for the month was the Mexican peso, which traded down as Donald Trump's poll numbers improved, trading almost to 20:1 per dollar before ending the month closer to 19.5:1.

Equities

Equities performed well for the quarter, recovering from the post-Brexit swoon in late June and rising strongly in July and August before flattening in September. In spite of the fifth straight quarter of falling S&P 500 earnings, high-beta technology and consumer discretionary stocks led the market higher, as investors and traders were willing to bid even higher multiples for companies with growing earnings or popular products. The lack of a post-Brexit crash in markets for the UK/Euro economies, coupled with continued assurances of easy money policies by the worldwide central banks, helped push up equities starting in July. The S&P 500 ended the quarter at 2,168.27, adding 3.85%, the largest quarterly gain of the year. The technology-heavy Nasdaq was up 9.7%, after gaining virtually nothing during the first half of the year.

Overseas, stock markets rose strongly, picking up momentum after the much-vilified Brexit vote failed to yield the apocalyptic results predicted by many experts. The Hong Kong market gained 9.9% during the quarter, and European markets were not far behind: Germany's DAX gained 8.7%, Spain's IBEX 35 gained 7.5% and England's FTSE 100 was up 6.5%. Japanese, South Korean and Indian markets also gained during the quarter. European financials were a notable sore spot, led down by Deutsche Bank, the largest European bank with rumors of capital deficiencies and fines from past "sins" causing the stock to sink during the quarter.

Year-to-date, stocks have turned an underwhelming year into surprising gains, with the S&P 500 up 7.84% (including dividends) in the first nine months. The sectors with the largest gains for the year are Energy, Utilities and Telecom, which had very strong first-half performances. The laggards are the Financial, Healthcare and Consumer Discretionary sectors, with the Financials only positive after dividends are included. Continued low interest rates and a flat yield curve continue to hurt earnings of the Financials. Year-to-date, our precious metals mining stocks and industrials continue to perform very well, in spite of correcting some during the quarter.

Precious Metals

Precious metals performed well during July in the post-Brexit angst, but flattened out during the rest of the quarter, with precious metals miners giving back some of earlier year gains. Gold was down less than 1% during the quarter, ending at $1,313.30/oz. Silver outperformed during the quarter, rising almost 3% and ending the quarter at $19.139/oz. Mining shares, as represented by the Van Eck Gold Miners ETF (GDX), were down 4.6% during the quarter, although many miners performed better, as exhibited by the Global X Silver Miners ETF (SIL) which was down 3.2% for the quarter.

Year to date, the precious metals investments are still the best performers. Gold, as represented by the SPDR Gold Trust ETF (GLD) is still up 22.11% year-to-date, while more volatile silver is up 37.98%. Miners still have performed spectacularly (off a very depressed base at the end of 2015), with the GDX Gold Miners ETF up 87.58% and the SIL Silver Miners ETF up 136.22%

Energy

Energy prices were volatile but ended the quarter slightly lower. WTI lost less than a percent to close at 48.24/bbl, while Brent was weaker, falling more than 2% during the quarter. Natural gas rallied during August and at the first of September but gave back much of the gains, ending the quarter 1% higher at $2.91/MMBtu.

Year-to-date, energy prices are substantially higher. WTI is +30.24% since the first of the year (including a huge first-quarter swoon). Natural gas has gained 24.35% year-to-date. Both have benefitted from production cuts and limitation agreements, continued worldwide demand growth and perception of continued (albeit slow) worldwide economic growth. On the more concerning side, crude oil and oil products (gasoline and diesel/distillate) storage levels are still at multi-year highs.

Bonds

Bond markets performed very differently during the quarter, with each type of bonds showing divergent results as investors' risk appetites re-emerged. Long-term Treasury bonds fell in value slightly during the quarter, with yields rising from 1.492% at the end of June to 1.605% on September 30th. International selling, due to budget deficits in oil-producing countries and changing reserve mixes in Asian countries, caused part of the decline, while buying by insurance and pension plans limited losses. US high yield bonds rose, following higher equity markets and helped by oil prices in the high $40s/bbl; the US High Yield Index was up 5.4% during the quarter. US municipal bonds and investment-grade corporates generally saw small losses (and high yields) in the period. Internationally, European bonds rallied, with EU high yield and financial debt returning around 4%, while European sovereigns underperformed, returning on average less than 1% for the quarter.

Other Markets

Currencies were very volatile during the quarter, especially around the June 23rd Brexit vote. The British pound, after losing ground in the second quarter, tacked on a further 2.5% loss versus the US Dollar in the third quarter. Most other developed country currencies were higher (and volatile) versus the dollar in the third quarter, although the gains ended up being relatively small: yen +1.7%, euro +1.2% and Swiss franc +0.5%. NAFTA currencies were down vs. the dollar: the Mexican peso was -5.7% while the Canadian dollar was -1.6%. Analysts generally blamed the uncertainty around the US presidential election along with the Fed staying on hold (due to less-than-spectacular US economic data) for the weaker US dollar.

Year to date, the US dollar is still down, meaning both the euro (+4.5%) and the yen (+15%) are the strongest currencies, while the British pound is the big loser (due to Brexit uncertainties), down around 16% so far this year. Other currencies, like the Russian ruble and Chinese yuan, are also down on the year, with the yuan down approximately 6% year-to-date, a not insignificant drop, the scale of which led to market disruptions in August 2015 and January 2016.

In commodities, grains and meats performed well during the first half of the year but gave back a large chunk of their previous gains in the third quarter as excellent weather in North America allowed farmers to produce a bumper crop of agricultural products and animals. For the third quarter, lean hogs lost 47.2% of their value, while soybeans (-17.3%), live cattle (-12.8%), wheat (-9.8%), corn (-9.3%) and rough rice (-7.1%) were all down strongly too.

Going Forward

Economy

The economy has been uneven this year, slowing from a peak in the second quarter of 2015. While employment numbers have held up better (although they are notoriously volatile in revisions, which happen up to 2 years later than first reported), employment gains have still generally trended down since last fall (with a couple of strong months interspersed early this summer). As you can see in the chart below (from TradingEconomics.com – United States Non-Farm Payrolls), payrolls look to be on a downward slope, and the employment situation has been one of the main tenets of the economy that was believed to be strong.

The Fed's own Labor Market Conditions Index, which is rumored to be one of Fed Chair Yellen's favorite indicators [after all, her specialty is the economics of employment] was released in early October, and it continues to underperform headline Bureau of Labor Statistics employment reports. Having fallen to nearly -40 in 2009 and rising to +10 in 2010-2012, lately the index has been around the zero-line (separating growth from non-growth), but has started to fall off, with August revised down to -1.3 (from -0.7) and September printing a very weak -2.2 – far lower than recent employment reports would project. Since Chair Yellen is said to emphasize this index, we believe she must believe employment growth may indeed be slowing and care must be taken in trying to steer a weak, low-growth economy.

In addition, manufacturing measures of economic growth, such as Industrial production, capital goods orders and factory orders (to name a few important ones) continue to exhibit behavior that in the past have generally happened during recessions.

Throw in the uncertainties around the 2016 election and possible changes in policy – which almost certainly is guiding US industry to invest conservatively, if at all, (many companies are not re-investing, as shown by very low capital expenditures in aggregate) – and the economy seems to be in the very late stages of this expansion, with a not-insignificant risk of recession within months.

Thus, we believe the US economy continues to slow, which will guide policy as more and more economic measures show recessionary levels. We believe these factors, including an employment report on November 5th (3 days before the election), will put any November rate hike on hold and will introduce further uncertainty into the recent push for a December rate hike.

Internationally, things are actually very similar. While people keep trying to tout an occasional "green shoot" in economic releases, European economies are showing continued slowdowns in growth (most importantly in Germany), which has required Mario Draghi and the ECB to continue monetary stimulus at its accelerated rate. In China, official announcements put 3Q Chinese GDP growth at the predicted 6.7%; however, financial pundits put actual growth somewhere in the 0-3% range, with Chinese manufacturing showing the same semi-recessionary conditions as the US (ISM manufacturing surveys show a reading below 50, indicating contraction). Japan is also experiencing near-recessionary conditions, held back by a yen that has strengthened 20% in the past twelve months and non-existent domestic demand growth. Emerging markets around the world have seen better growth, but the slump in oil and natural resource prices has held back growth in many of these countries.

All the prevailing economic conditions point to continued easy monetary policies, as can be seen by the Fed's reticence to raise rates in September, continued large ECB monetary stimulus, increased stimulus occurring in China and the turn toward easier monetary policy in recent announcements by the Canadian and Australian monetary authorities.

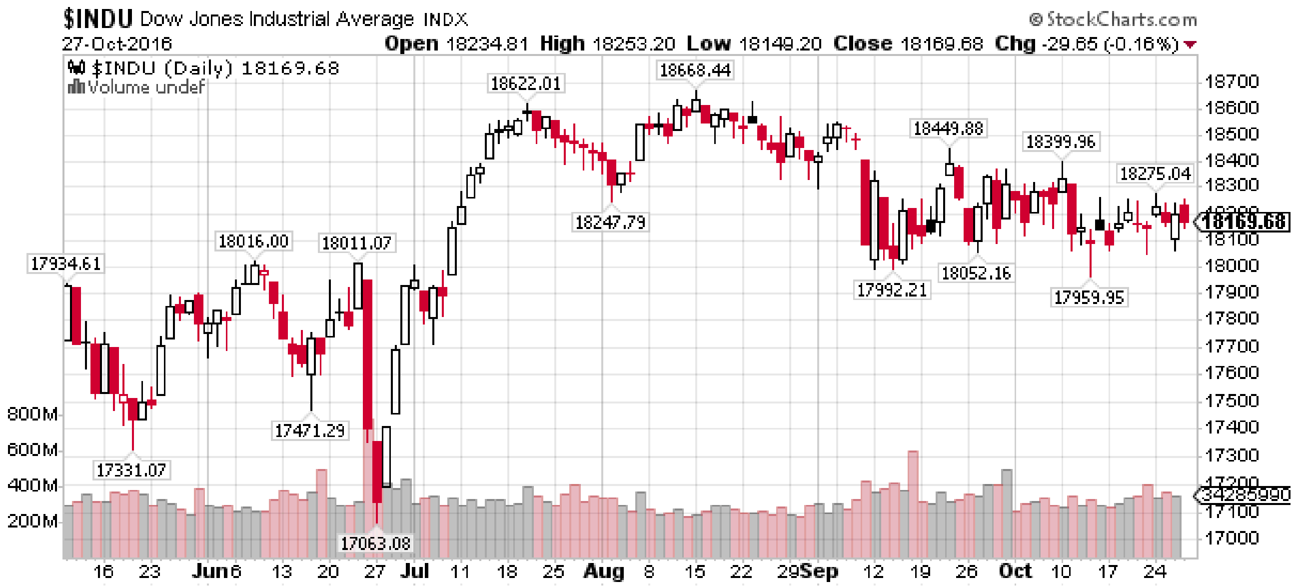
Equities

Despite our pessimism about the economic deceleration happening in the US, Europe, Japan and China, we are still constructive about parts of the equity markets due to the abovementioned monetary stimulus of the past and present and our conviction that a true recession OR a large equity market drop would cause a new episode of monetary stimulus (most probably as 'QE4' or the fourth episode of quantitative easing by the Fed since 2008).

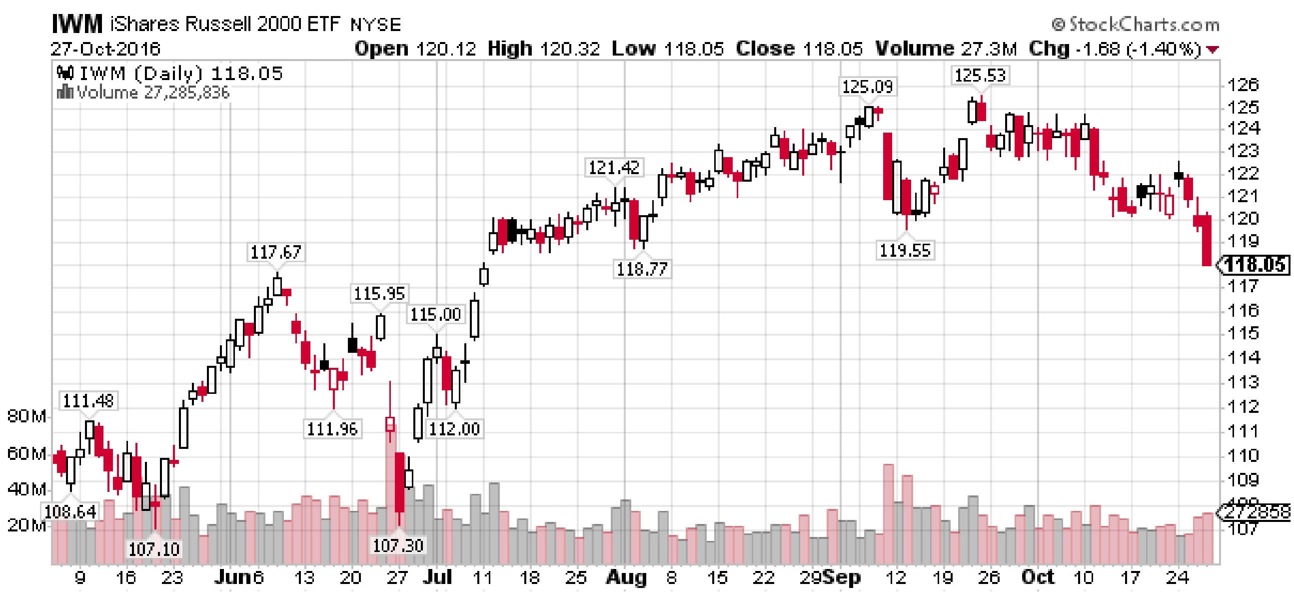
On a shorter-term spectrum, the market appears to be "tired" [technical term] where stocks have not hit new highs in a few weeks and are showing more selling than buying each day – especially late in the day.

Looking at the charts, the Dow Jones Industrials have held up better in October than the rest of the market; this is often a sign of narrowing of interest in the stock market, which often precedes a correction. The first chart below, showing the Dow Industrials, shows a roughly flat market from mid-September to late October. The Russell 2000 index (the lower chart), which includes a large smaller stocks, is down approximately 6% in October and looks distinctly weaker than September price action.

The Dow Jones Industrial Average chart:



The Russell 2000 index chart:



We expect weakness between the election and January, but we also believe this weakness will force the Fed to be more accommodating once again (as occurred in August 2015 and February 2016). This should put a further bid in equity markets and runs the risk that inflation will flare up more at the same time.

Precious Metals

Precious metals continued their correction in early October, falling back to support levels in the $1250/oz // $17.00/oz range as Fed rhetoric for higher short-term rates pushed down their near-term prospects in traders' eyes. We see this weakness as part of the mid-year corrections after a sharp rise in the gold/silver prices this year. We believe continued economic weakness and more reports showing weakening economic statistics will take equity prices lower and again force the Fed to flip-flop to more accommodative policies once again in early 2017.

On the technical side, gold and mining stocks seemed to have found strong support at the (rising) 200-day moving average, usually a strong point of support after a correction (the red line in the chart below). In addition, the $1250/oz level is approximately a 50% retracement of the trough-to-peak of the 2016 rally, often an area of strong support. We think the "textbook" correction has run its course, and gold (and silver) should head higher as weakening economic reports force world central banks to continue to be accommodative.

We often cite the Gold Stock Analyst as one source that has good statistics about gold-related investments. They measure the historical valuation of mining stocks versus gold itself and estimate how over- or under-valued gold stocks are. Currently, GSA believes they are approximately 19% undervalued, and with many currencies trending lower and oil seemingly having peaked, we see profit margins ready to expand again and miners facing an even brighter future. Precious metals mining stocks closed the gap on being more than 50% undervalued last year to 15% undervalued late in the summer, and we see another structural re-rating in valuation as a value driver to higher mining company stock prices in 2016/17.

As we reference later in this Letter in the Q&A section, we see measured inflation heating up, and we believe higher inflation will start to affect investors' appetites toward traditional inflation hedges, like gold. The Commodity Research Bureau's index of commodities (which often shows a rise when inflation starts to be a concern) bottomed out during early 2016 and has moved higher since, reflecting tighter supplies due to under-investment for the last 5+ years. As we look at many industrial metals and other components, they show a large rise in price this year, which we think points to rising inflation. When people start to realize inflation is here for real (probably during 2017), we see gold as a huge beneficiary.

Energy

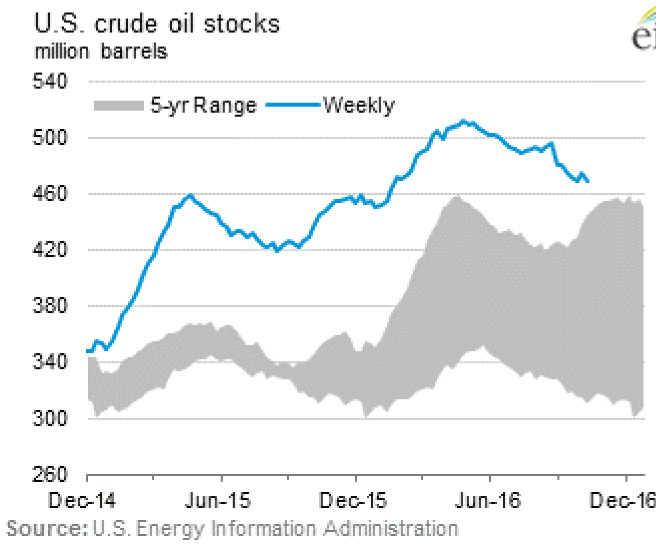
Crude oil prices have shown real resilience during September and early October as the promise of some kind of production cut or ceiling agreement was reached during a late-September OPEC conference in Algiers. In addition, several analysts have put forth the opinion that the drop in prices in the last couple of years has cancelled enough non-OPEC drilling prospects that prices will need to rise to the $60-80/bbl range to 'green light' enough new production projects to balance demand over time.

We believe there has been enough production curtailed in the short term in Africa (north, west and south) and in the Americas (especially Venezuela) to cause recent firmness in prices. We also believe that higher prices will occur in the future as long-cycle projects (offshore in the Americas, Africa and Europe) don't come on in the next few years due to low price concerns.

However, we also believe current producers are incentivized to maximize production currently, which should not only put a lid on prices, but probably force crude oil prices back to the low $40s/bbl or possibly into the $30s as demand has a hard time keeping up with supply in the next few months.

What reasons do we have for this prediction? We (like others) are trying to figure out oil's supply and demand which, being a worldwide industry, is difficult. It is made even more difficult by money flows of traders pushing prices up and down, which may or may not have anything to do with supply and demand. So, our 'signposts' for trying to gauge supply and demand are:

1) Crude oil storage levels – worldwide storage levels reached 70-year highs this summer in the US. While levels have come down (see graph below from the US Energy Information Agency), storage levels are still far above any highs seen in the last few years going into the winter demand slowdown.



This situation is true in other parts of the world too, most importantly in China, where crude oil storage levels are at all-time highs as the Chinese finish filling their strategic petroleum reserve this year. Additionally, the oil trading markets responded last week to new reports of exports of petroleum products from China, indicating a surplus of crude and refining capacity that should lower worldwide prices as China turns from large consistent buyer to seller (courtesy of Dennis Gartman in The Gartman Letter ("TGL") 10/21/2016).

2) Increased drilling as indicated by rig counts – US rig counts are up as crude oil reaches $50/bbl+; Baker Hughes reported on 10/14/2016 that the US rig count rose for the 16th straight week to an 8-month high of 432 rigs. Rig utilization is also climbing around the world, indicating even more supply is headed to oil markets. Oil analyst Ronald Smith of Citigroup, in a October 3rd note, reported that during 2014-2016, while North America and other regions saw rig count drops of 50-75%, rigs at work in Russia have actually grown 25% since 2014, leading to higher production throughout the 2014-2016 period, including another 200,000 bbls/day just added in September to push total Russian production to another multi-decade high of 11.8 million bbls/day.

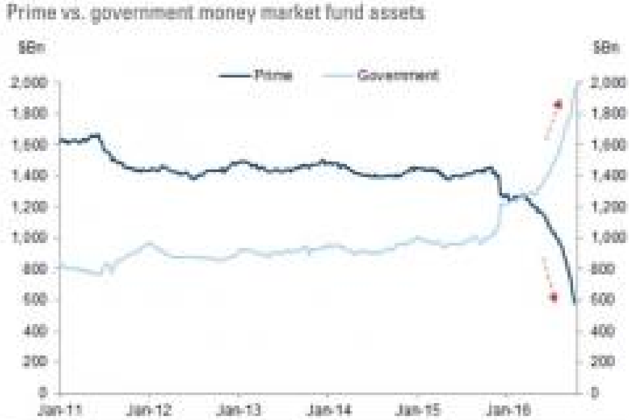
3) Lack of pricing incentive for producers to cut production – worldwide producers have seen prices rise in recent months to a point where even higher-cost oil projects are being "green-lighted" for approval. With this kind of optimism, producers are looking to maintain their market-share (or grab more, if they can manage more production). Igor Sechin, CEO of the largest Russian (partially government-owned) oil company Rosneft, commenting on the recent Algiers production "ceiling" and whether Rosneft would freeze production, said: "Why should we do it? … Try to answer this question yourself: Would Iran, Saudi Arabia or Venezuela cut production?" [recounted by Dennis Gartman in 10/13/2016 TGL]. His remarks were delivered after he announced Rosneft would produce more this year than in 2015.

We think these three reasons show the influence of waning demand and increasing supply that will overwhelm recent bullish trading flows during the winter. We plan to keep our underweighting on energy stocks, especially producers, until we see a better alignment of pricing and fundamentals. We think the large rally in energy equities we have seen since February will correct severely, taking away all the gains in the S&P for the year, much of which is attributable to the widespread energy stock rally. However, we will continue to opportunistically look to add to our pipeline/MLP exposures since they are far more dependent on flows than oil prices.

Bonds

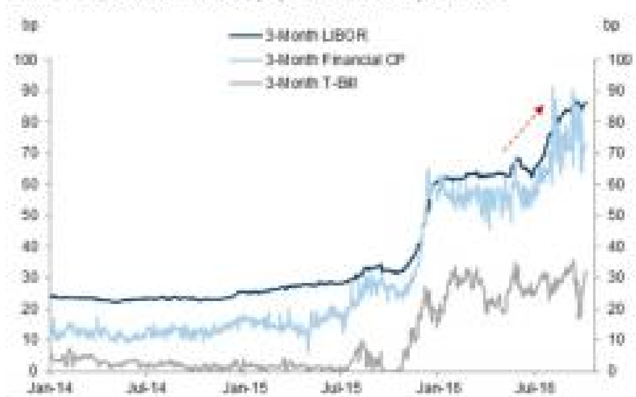
A lot is happening and is at stake in the fixed income markets. In short-term rates, the Fed appears nearly hell-bent on raising the Fed Funds rate, despite weakening data. Meanwhile, a mid-October change in money market fund legislation has caused a bifurcation of money market funds – "safe" funds that only have government or government-backed short-term bills and commercial paper and other short-term non-governmental short-term "paper" that is not "as safe". As funds have shunned non-government paper (leaving that to the former money market funds that are now classified as "short term bond funds"), these issuers' inability to get funding has caused interest rates governing these instruments – Libor – to spike (see the graph below, from an October 14 article on Zerohedge.com).

Exhibit 1: $850bn of assets have rotated out of prime money market funds…
Prime vs. government money market fund assets



Source: ICI and Goldman Sachs Global Investment Research

Exhibit 2: …causing 3-month CP and LIBOR rates to widen 20bp vs. T-bills since May
3-month LIBOR, commercial paper and Treasury bill rates



Source: Bloomberg, Company data, Goldman Sachs Global Investment Research

3-month commercial paper has risen in yield (fallen in price) by over 20-30 basis points due to this new regulatory regime. Thus, with Libor up 20-30 basis points in the past couple of months, it seems like a quarter-point tightening has already occurred in the market; if the Fed presses on with its rate rise, it will push rates even higher. But the Fed is concerned with the "optics" of not having raised rates with employment having improved, so it appears that the Fed will raise rates in December, further tightening at a time when a quarter point has already effectively occurred.

On the long-rate side, worldwide rates have been driven by the ECB's large buying of bonds, which has caused European and US and other bonds to rise in price / fall in yield as bond supply available to the market falls. Lately, as Fed buying for reinvestment has waned (the US monetary base is down nearly $500 billion from its peak last year as the Fed lets some of its bond holdings run off without reinvesting the money) and rumblings of lower ECB buying in the future circulate, European bonds have fallen in price / risen in yield, which has affected US rates, with rates have risen to 1.88% on the 10-year Treasury at one point this week. We believe the hawkish talk out of the Fed and a slowing of economic deterioration in Europe has caused the bearishness on LT bonds. We expect as winter further slows economic growth and the reality of a dysfunctional US government sinks in, investors will again be drawn to the safe yield of US Treasuries, driving up prices and lowering yields. We also see investors trading out some of their large equity holdings for Treasuries when we see the next correction hit the equity markets.

Other Markets

Currency markets have been at the forefront of central bank moves and easing programs, as different countries / regions attempt to jumpstart their economies through growing exports made more attractive by lower exchange rates. As world economies continue to slow, we see these "currency war" moves becoming more common place and expect the euro (and probably the yen) to be the major currencies that should fall against the dollar (along with the Chinese yuan, which recently hit six-year lows). Great Britain, with its pound down significantly already this year, is seeing stronger exports and stronger GDP readings since their exports have become much more competitive. We continue to maintain a short position in the euro and yen, and we will look for opportunity to add to these positions if the dollar starts to appreciate again.

Other currencies, namely the Canadian, Australian and New Zealand dollars, appear to have stabilized against the dollar, as higher commodity prices have shown a recent uptick in economic activity. While we see commodities trending higher in the future, we think the non-commodity parts of these economies (especially ultra-high housing prices) will weaken, which will probably weaken their currencies in the longer run. Our discussion of the Mexican peso is in the Q&A section near the end of this letter. We don't anticipate taking direct position in these currencies, but this outlook will be reflected in our stock and bond picks that may be affected by these currencies.

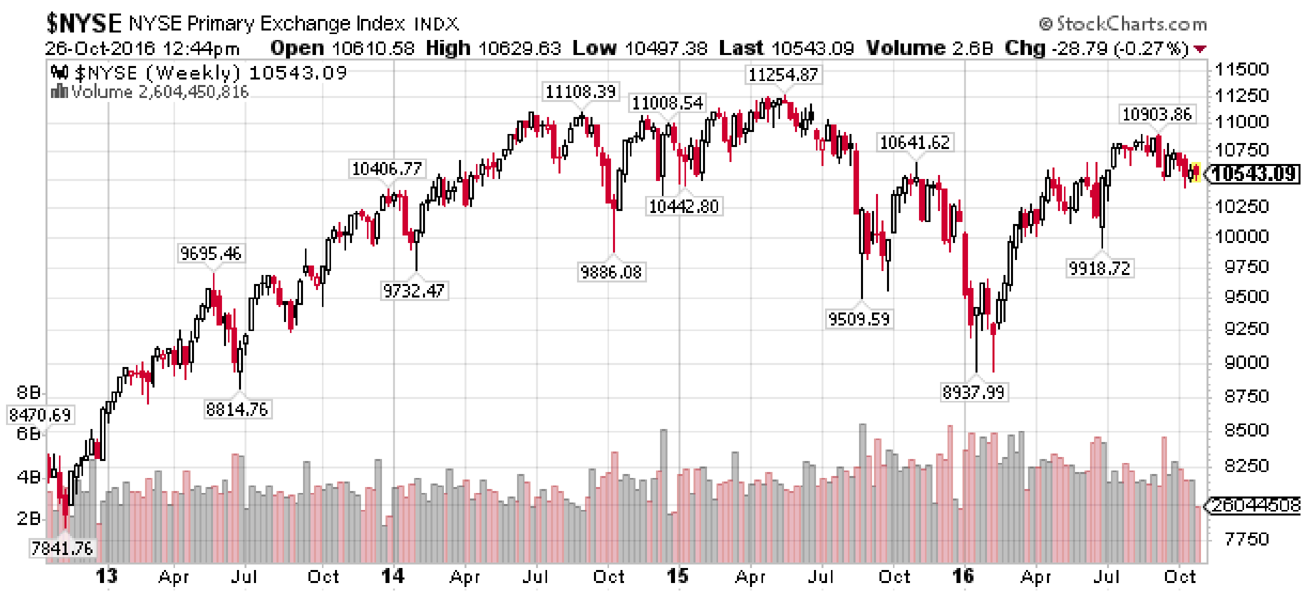
Kanos Quarterly Commentary

Questions for the Portfolio Manager

We have included a section yearly where we incorporate investor questions and our answers in a Q&A/interview format to give you a better idea of our current thought process and portfolio management strategies.

Q: Where do you think stock prices are going and why?

Kanos: We will answer this in two parts. First, we believe stock indices have risen due to ultra-low interest rates, the lack of yield in safer fixed income investments, the US being a safe haven for investments from around the world, and the belief that the Fed has engineered a recovery that will [finally] grow enough to allow higher interest rates. We don't believe some of these reasons are sound footing for investing in highly-valued growth stocks (the current market leaders), but we do think we can grow your wealth in this environment. The second, and more important point, is that most stocks are NOT going up – it is the very large stocks that have propelled indices to new highs during the summer, while most stocks have not done nearly as well. As an illustration of this, we look at one of the widest measures of stocks – the New York Stock Exchange Composite, which shows all the stocks listed on the NYSE. As you can see below, it started to flatten midyear 2014 when quantitative easing was winding down (it ended in October 2014). From there, it set a slightly higher high in May 2015 but has not regained that level in 2016 (although the technology-heavy Nasdaq peaked in August 2016). Thus, on average, stocks are lower now than May 2015, and, from the look of the chart, may be headed lower. Thus, it shows why picking the right sectors and stocks is so important. In addition, we continue to think most are underestimating the risk of the downside in the very expensive tech stock sector that has led the market for the last couple of years.



Thus, we see the market as being vulnerable and believe the indices will head lower as the US economy stagnates and large growth stocks see their valuations contract. However, we also believe that the Fed will add more monetary stimulus to the financial system, which will then push back up stock prices. We believe our current portfolios would fare far better than major US stock indices in this scenario, similar to our outperformance in August 2015 and February 2016.

Q: How are the results of the election going to affect markets?

Kanos: Having watched the events around the UK's "Brexit" vote closely, we believe this presidential election has many of the same uncertainties as the Brexit vote, including the press being almost unilaterally for one side – the one which didn't win but was widely reported to be the favorite. Thus, we think the coverage and polling of the presidential election has been very one-sided. This makes it even harder to gauge, due to the difficulty of measuring peoples' disaffection and propensity to vote to shake things up.

With that being said, the market seems to have priced in a Clinton victory and a near-standoff or slight Democratic majority in the Senate, while the House is widely expected to stay Republican. This governmental setup closely resembles current dynamics, so we don't think the governmental influence on markets will change appreciably, except, of course, if we get a Democratically-controlled Senate; however, this will probably produce a lot of venom, but not too much action, especially with the House almost certainly not being able to pass any significant policy changes.

So how do markets react? We believe the rise of computer trading and the emphasis on Fed policy to determine future market direction has led to markets only discounting the very near future. Thus, if Hillary wins the election, the Dems get control of the Senate (without any significant majority, of course) and the Republicans keep the House, we see the markets starting to focus on a difficult, stormy term for Clinton and believe the markets will correct, especially because the Fed seems virtually dead-set on raising rates in December, with the election having passed. These two elements, we believe, should lead to stock market weakness in late 2016/early 2017 and will set up a buying opportunity later in 2017.

Q: You have stated that you don't think the Fed should raise rates, but you think they will in December. Can you elaborate on that?

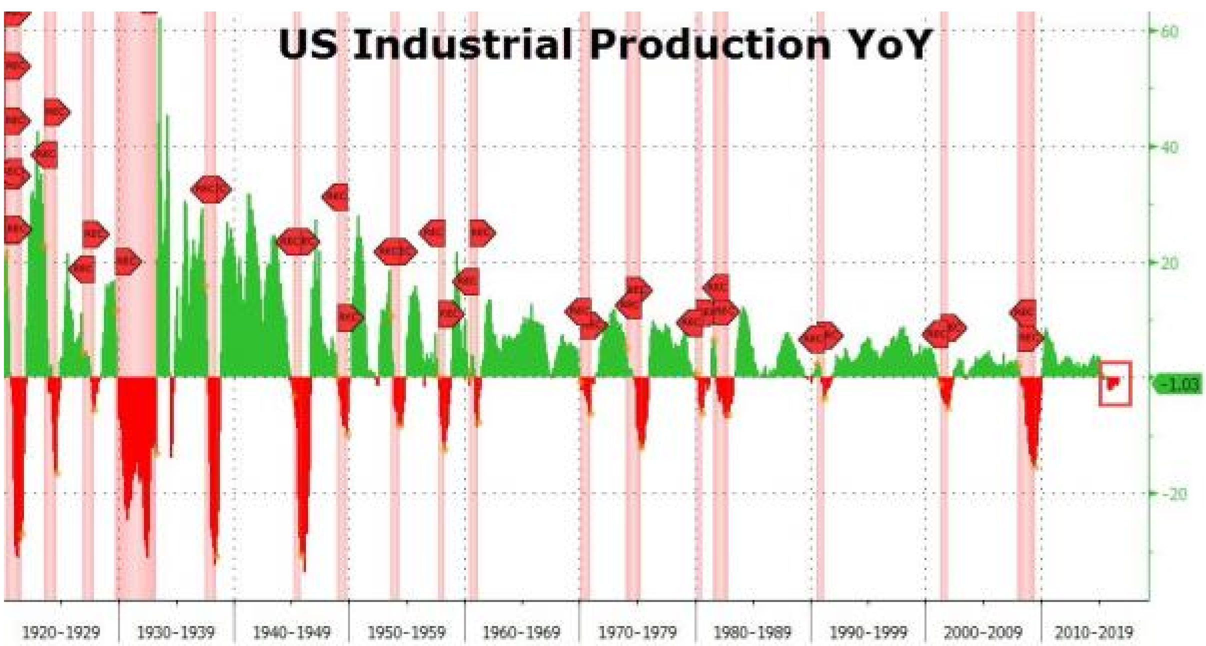
Kanos: We believe the Fed has missed its window to raise rates due to a slowing economy and building recessionary risks. If the Fed had raised rates in 2013 or 2014 when the economy showed slightly higher growth and unemployment was dropping steadily, the stock market may have corrected but the country would be closer to what the Fed sees as "normalized" interest rates. However, the Fed has continued to state that the economy is improving and that they are close to raising rates now. Since they haven't done so, a number of voices in business and government have started to call them out for the incongruity of their words and deeds. Various FOMC members have also commented that they could lose credibility in the markets unless they change either their forecasts or raise rates. We think they are truly embarrassed by this criticism and will raise rates to avoid further embarrassment, despite the risk of higher rates pushing the US into recession in 2017. We think that if rates are hiked (just like happened in late 2015), we will again see lower stock prices afterward as the market realizes the economy is weaker than thought, and profits are hurt by the resultant higher dollar after the rate hike.

Q: There has been talk of the US facing recessionary risks in 2017. Do you see these risks as being significant? Many commentators are telling us the economy is doing fine and stock prices have held up. Can you give us some more evidence of why you think the economy is slowing?

Kanos: We think there are plenty of indicators of a slowing economy, many of which are rarely seen outside of recessions. Some of them are:

1) Employment – the slowing of employment growth [seen in the Economy section of Going Forward above] is a lagging indicator, meaning when it starts to drop, you are usually entering a recession – so it could be closer than we think. In addition, job OPENINGS may have peaked, and if so, then a recession may have started; the National Federation of Independent Businesses small business optimism survey (reported monthly) is widely-followed because small businesses are the jobs engine of the US economy, dropped in September. The NFIB's 'job openings component' plummeted from 30 to 24, or "from a cyclical high to the lowest level in 15 months" according to analysts Xian and Denyer in a Gavekal Research Daily note on 10/12/2016. This reading, along with a drop in the monthly JOLTS (Job Openings and Labor Turnover Survey) number in September, shows that jobs seem to be getting scarcer.

2) Industrial Production –a 10/17/2016 Zerohedge article on industrial production reported "**For the 13th straight month US Industrial Production contracted year-over-year.** The 1.00% annual drop extends the weakness to the **longest non-recessionary streak in US history**… Capacity Utilization also missed expectations hovering at cycle lows around 75.4%..." In the graph below, the pink columns represent past recessions, and the red areas show Industrial Production drops, with the current one boxed on the right of the graph – it is currently a shallow but persistent series of drops.



3) Yield Curve Flattening – many market commentators believe the US cannot have a recession unless the yield curve, the curve formed by the different maturities of US Treasury bonds, inverts. However, with the Fed pegging short-term rates near zero, it would appear this indicator may not be as relevant since the market is not determining rates for short maturities. However, there is an alternative – many economists like to use Stanford economist John Taylor's "Taylor Rule" which is a formula for determining where Fed Funds Rates (very short-term interest rates) should be with respect to other economic indicators. Plugging in a current inflation rate of 2.2% (the 12-mo core inflation rate),

target inflation rate of 2%, potential US GDP of 3% and current US GDP at 1.8%, the Taylor Rule formulaically predicts the short-term interest rate should be 3.7%, far above the 30-yr Treasury yield around 2.5%, which would indicate an inverted yield curve, absent Fed manipulation. Thus, we could be very close to a recession, which often happens within a year of the yield curve flattening/inverting.

In addition, the 10/21/2016 Investech Research newsletter points out a telling statistic: "Over the past 88 years, 9 of the 14 US economic recessions began in the year following an election. Additionally, 3 others began during a Presidential Election year (1948, 1960 and 1980)." Thus, there were 22 election years in the past 88 years, and 12 of them had recessions start during the year or the year after.

Q: You continue to talk about inflation, and many of your investments would benefit from higher inflation. Are we seeing evidence of higher inflation yet?

Kanos: Inflation is starting to impact prices all along the spectrum, although the non-reporting by the press means that it is not widely realized yet. Statistically, inflation is not yet at worrisome levels for policy makers. However, as we will see, the overall statistics don't tell the whole story. The Consumer Price Index (CPI) rose 1.5% year-on-year (yoy) through September 2016, the highest reading since October 2014 and up from 1.1% last month. The "core" CPI, which excludes volatile food and energy prices, was up 2.2% (yoy), the 11th straight month above the Fed's 2% inflation target. The main "culprits" were 'Shelter' (housing costs) up 3.4% and 'Medical Services' up 4.8%. These are some big numbers. Factors falling in price included communications and apparel. The CPI calculation does not include tuition for private schools or colleges, but from personal experience, those are slated to rise 5-6% on average in the current and following years. In addition, future inflation will almost certainly show much higher readings as the low energy prices seen last fall/this past spring become the comparison point – energy prices could show yearly gains of up to 50%. Finally, the "Affordable" Care Act health care premiums are slated to rise ON AVERAGE by 25% next year, with Arizona ACA premiums rising more than 50% for 2017! Between energy and healthcare, we should start to see the inflation we all feel in our wallets emerge in the statistics and on the news.

This emergence should help cement investors' need to protect portfolios against rising inflation, and our inflation-oriented positions should benefit even more during 2017.

Q: Where do you think the peso is going?

Kanos: The peso has been lately been moving in direct response to where Donald Trump is in polls – as Trump rises, the value of the peso drops, and vice versa. Lately, as Trump's fortunes appear to have risen, so the peso has dropped. However, if you look at the chart of the peso below, it has been weakening since mid-2014. Thus, the Trump effect has not been the major reason for the weakness. The weakness of oil prices and the resulting slower economy, coupled with the unpopularity of President Pena and the unresolved crime problem, are the main reasons for peso weakness. Those reasons haven't gone away, although oil prices have risen and stabilized for the time being.

The chart seems to tell us that unless the peso breaks below 17, the peso could resume its weakness and possibly breach 20. However, if oil prices can stay in the $50s-60s/bbl (or higher) and Trump loses the election, the peso could stabilize and possibly go higher (depending on higher oil prices). Since we believe oil prices will trend lower before they head higher, we think the peso is vulnerable, especially if the Fed raises interest rates in December.

The Managers of Kanos Capital Management