KANOS
CAPITAL MANAGEMENT, LLC

Fourth Quarter 2014 Investor Letter

Portfolio Comments

The volatility in many financial markets during the fourth quarter allowed us to further diversify our portfolios to try to take advantage of different opportunities in different markets. We expanded our currency positions by adding short euro positions. We took a contrarian approach of slowing US economic growth to establish long-term Treasury bond longs at favorable prices (which had risen but were not being bought by traditional portfolio managers). We even selectively added some conservative stock positions even in the face of two large selloffs during the quarter (in early October and early December). A number of our points of view bore fruit, although our precious metals gave back the year's gains and our energy positions suffered due to energy's extreme weakness. Tax-loss selling led to lower prices in most of our precious metals positions, exaggerating end-of-year weakness in prices; however, as of mid-January, those positions had more than recovered all of their 4Q2014 losses. All-in-all, this was a quarter of transition, where yen and euro weakness and the energy price collapse are setting up to either draw investment dollars from around the world, driving up US markets, or cause US exports to drop, profit margins to shrink and stock and bond markets to weaken. Stay tuned.

Fourth Quarter Market Conditions

October started the quarter in a rocky fashion, exhibiting volatility in many asset classes, and most notably in US Treasuries. For the month, the beaten-up agricultural commodities made a comeback, with corn and wheat rising 17% and 11%, respectively. Stock markets made up the rest of the big winners, with the Russian Micex, Hong Kong Hang Seng, US S&P 500 and China's Shanghai index the winners with greater than 3% gains. Losers were commodities, led by oil, which dropped about 8% for the month, and gold and silver, which lost 3% and 5%, respectively. The worst asset performer was the Greek Athex stock index, which lost about 12%, followed closely by other weak European indices: the Portugal General down 9% and the Italian MIB Index down more than 5%. While high yield, emerging market and US Treasury bonds all ended up with small gains for the month, they showed a lot of volatility, led by the 10-year Treasury, which on the morning of October 15th, went from 2.20% to 1.85% in less than an hour, closing at 2.10%. This was the most volatility seen in the Treasury complex in years (or maybe decades), as equity volatility and portfolio rebalancing led to a "flash crash" in the Treasuries. The S&P 500 showed a near V-shaped pattern during October, as poor economic news and oil led equities down for the first part of the month, followed by a complete recovery in equities during the second half. The S&P 500 returned 2.44%, led by the Utilities, Healthcare, Industrial and Consumer Staples sectors. The Energy and Materials sectors were both down for the month. Some extra excitement happened on October 31st when the

1217 South Shepherd
Suite 200
Houston, Texas 77019
www.kanoscapital.com

Japanese Central Bank announced an expanded quantitative easing ("QE") program at the same time that Japan's GPIF Government Pension Investment Fund announced new investment targets, cutting back on Japanese bonds and upping exposure to Japanese and foreign equities. These moves led to a huge rally in Japanese stocks (and worldwide stock markets), and a big fall in the value of the yen.

November showed mostly the same results as October, but in a less volatile manner. Winners were the Chinese Shanghai index (up about 10% for the month on Chinese fiscal reforms and hope for more monetary stimulus), wheat and most European indices led by the German DAX (but interestingly also including the Greek Athex and Spanish IBEX indices). Losers during November were oil again (down nearly 15%) and to a lesser extent industrial commodities like copper and silver, both down around 5%. European bonds were up during the month, as markets anticipated monetary stimulus from the ECB. Japanese stocks also did well, as the yen plunged during the month, down more than 6% after the 10/31 JCB and GPIF decisions mentioned above. Most other assets, including US bonds, were relatively flat during the month. The S&P 500 gained 2.69% during November, led by the Technology, Consumer Discretionary and Consumer Staples sectors. The Energy sector was the big loser, down 8.5% for November alone, on the heels of the crude oil price collapse. OPEC met on Thanksgiving and couldn't agree on production cuts; the next trading day (11/28), crude plummeted and energy stocks (and many other materials stocks) had possibly the worst day of the year, down significantly across the board. Gold ended up relatively flat for the month and materials stocks were slightly higher for the month.

December was a roller coaster ride with US equity markets initially pulled down by oil weakness but eventually boosted by soothing words from the mid-month Fed meeting. The S&P 500 ended down 0.25% for the month, but its trading range was 121 points or 6.1% during December. Winners were the Utilities, Financials and Consumer Discretionary sectors, while Telecom, Technology and Healthcare were laggards. Chinese stocks were again the big winner worldwide. Greece's Athex and the Portugal General indices were quite weak in Europe, and Russia's Micex stock index was again a big loser as oil prices continued their plunge, closing the year at $53.27/bbl. US natural gas plummeted during a relatively warm December, losing more than 25% of its price and ending under $3.00/MMBtu. Bonds did well during the month: US 10-yr bond yields fell to 2.174% and 30-year yields settled near new all-time lows at 2.749%. Gold nudged lower for the month, ending the year around $1,180/oz. Interestingly, most large hedge funds performed very poorly during December, led lower by Caxton Global (-5.60%), Fortress Macro (-4.67%), Paulson Advantage Plus (-3.66%), Paul Tudor Jones' Tudor BVI Global (-2.59%) and Eclectica (-1.50%), further hurting the 2014 performance of active managers.

Equities

The S&P 500 was up 4.93% for the quarter, led by Utilities, Consumer Staples and Consumer Discretionary. Losing for the quarter were the Energy, Telecom and Materials sectors. For the year, the total return for the S&P 500 reaching 13.69% for the year but trading at a very expensive 16.4x forward earnings, according to the Wall Street Journal. Most of the gains were concentrated in a few sectors, most of which have very high valuations. The big winners for year were: Semiconductors

(+33%), Biotechnology (+31%), Alcoholic Beverages (+30%), Healthcare Providers (+28%) and Electric Utilities (+24%).

In worldwide equities, the big winner for the year was Chinese stocks, which gained almost 50% (as represented by the Shanghai Composite index) during 2014. Japan's Nikkei and Hong Kong's Hang Seng were also up for 2014, while Portuguese and Greek stock markets were big losers, down almost 20% and 25%, respectively. Russia's Micex index fell almost 40% in US dollar terms due to lower oil prices and sanctions. Major European bourses in Germany and France were up slightly on the year.

Precious Metals

Gold and silver rallied during early October as financial markets weakened. However, when the US stock market rose sharply during the rest of October and early November, the precious metals gave back their gains and dropped to the lows of the quarter as investors poured into the recovering US stock market. When the Chinese central bank eased further in mid-November, gold rose. The day after Thanksgiving, when OPEC's Thanksgiving production decision led to large declines in all markets, precious metals also dropped hard, as did almost all financial assets. The next trading day (12/1), gold staged an outside reversal, setting a new low and finishing the day above the prior day's range, which is a bullish technical bottoming sign; silver had a near-outside reversal too. For the rest of December, the precious metals treaded water, closing the year with a small loss of approximately 0.5%. As noted above, precious metals stocks underperformed gold and US stocks in general, with end-of-year exaggerated losses due to tax-loss selling. Gold ended the year with a 0.5% loss while the more volatile silver ended more than 15% lower for the year.

Energy

Much of the motion in the markets during the quarter came about because of the weakness in crude oil prices during the fall and winter. Crude oil prices were affected by slowing Asian and North American demand, coupled with increases in supply from North American shale producers, Libya and Iraq. Saudi Arabia "fired the first shot" during the late summer when they lowered prices to maintain market share, and prices slid for much of the fall. Violent weakness in crude prices during early October led to a big selloff in the US equity markets, and crude prices continued to slide until the late fall OPEC meeting on Thanksgiving Day in Vienna. Many financial market participants expected OPEC to agree to some kind of limit on production, but when no cuts were announced and current quotas were extended until the next scheduled meeting in June 2015, prices collapsed around 10% on the Friday following (and took down virtually all commodities and many stock and bond markets). December didn't provide any relief, as crude prices continued to drop, falling to $53.71/bbl at year's end, down more than 46% on the year. Products didn't fare much better; in fact, retail gasoline prices dropped for 103 days in a row from September through December according to CNBC reports. Natural gas was much more weather-oriented, climbing nearly 33% from its late October low to over $4.50/MMBtu during much of mid-November as very cold weather blanketed the US in a series of early winter cold snaps. However, when the weather relented, prices fell and moved relentlessly

lower. Prices closed the year at $2.91/MMBtu, down almost 50% from its mid-November high of $4.69. Continued growth in production was the real culprit, as December cold weather snaps caused high heating demand but did not arrest the price from weakening further. We owned fewer energy stocks than in the past, having anticipated some price weakness during the summer; however, the violence of the decline shocked us, and we sold more positions during the quarter.

Bonds

Longer-term Treasuries were again a winner during the quarter, rising during early October when world stock markets plunged. After retracing half of the rise during the rest of the month, Treasuries rose gradually throughout the rest of the quarter, ending with the US long-term Treasury bonds, as represented by the iShares Barclays 20+ year Treasury Bond ETF, gaining 8.30% during the quarter and rising an incredible 24.28% during the year. High yield bonds were obviously very volatile during the quarter, with approximately 30% of the market consisting of energy bonds. High yield bonds dropped with stocks during the first part of October, but recovered most of their value in October and November. However, with the big drop in oil and other financial assets on the last trading day of November, junk bonds dropped again during early December before recovering somewhat at the end of the year. The fixed income markets, led by the US but also those in the Eurozone, were another major surprise in the financial markets. Beginning the year at 2.973%, the 10-year Treasury fell in yield (rose in price) virtually all year, confounding most traders and investors. As we realized world economic growth was slowing, we bought into the falling yield scenario and see it continuing well into 2015.

Other Markets

The other real "fireworks" in the financial markets besides in the energy sector involve the continued fall of major currencies against the dollar. The Bank of Japan announced expanded quantitative easing on October 31st in harmony with the Japanese Government Pension Investment Fund declaring large shifts in its portfolio into Japanese and foreign equities at the expense of Japanese government bonds. This expansion of easy monetary policy by the Japanese led to more weakness in the Japanese yen versus almost all currencies during November, although it ended flat in December. The yen ended the year at 119.7 per US dollar, up 13.7% from 104/$ at the end of 2013. Meanwhile, the euro weakened slowly throughout the quarter versus the dollar, and when ECB chief Mario Draghi indicated in the bank's mid-December meeting that quantitative easing was imminent at the January 22nd ECB policy meeting, the euro proceeded to drop almost every day through the end of the year, ending at 1.209 US dollars per euro, near lows not seen in more than four years. The euro ended the year down approximately 12.3% versus the dollar. Other currencies followed the yen and euro lower, especially Asian currencies whose economies compete against Japan (most notably the South Korean won, which was also down as much as the yen against the dollar). Finally, the Russian ruble was the weakest of the world's major currencies, dropping more than 100% versus its summer level against the dollar, moving from a level of 36 rubles/dollar in the summer to a low of 82 rubles/dollar before recovering to around 65 rubles/dollar at year end. The drop in crude prices, combined with

US/European sanctions over Russia's adventurism in the Crimea and eastern Ukraine, led to the weakness in the ruble. Oligarchs in Russia moved money abroad during the year in an attempt to preserve value, further weakening the currency by their relentless selling.

Going Forward

Economy

In spite of recent positive employment growth and a rising stock market, our analysis shows that the US economic growth is now stalling, starting last fall. While headline employment has been rising throughout 2014, the story behind the numbers points to lots of part-time, low wage jobs being created in the entertainment, leisure and restaurant industries. In the latest employment report (the December report released on 1/9/2015), employment rose 252,000 jobs but on average, wages FELL, an unusual occurrence that shows that the majority of jobs added were low-paying. December retail sales (excluding gas and autos) and industrial production were both down when reported in January, further evidence of actual slowing. In addition, the various Fed and industry surveys (like the manufacturing and services ISMs, for example) that measure the business climates in regions and large segments of industry have in the past couple of months virtually all fallen. This consistent weakness shows signs of slowing growth and a decelerating US economy. European economic surveys have been even worse, with extremely slow growth near the "zero line." Consumer prices in Europe during December actually fell, showing real price deflation. Asia in not much better, with Japan in recession (both 2Q and 3Q GDP measures showed contraction) and China exhibiting its slowest growth since 2008 (in the low 7% range officially, which many interpret as closer to 3-5% actual growth). With most governments having trouble passing any real reforms, virtually all of the world continues to rely on central bank monetary policy to provide stimulus that policymakers hope will lead to real growth.

So far, large doses of monetary policy have had less and less efficacy in fostering economic growth. Why? We believe the main culprits are two-fold: One, restrictive government policies (huge new Obamacare costs and regulations, relatively high taxes, growing regulation of more and more industries, more expensive and numerous government permitting, etc.) have led to high costs and less efficiency in businesses, meaning they have been spending more time on regulation than innovation. The second and more important is high debt levels. Taking the US as an example, aggregate debt levels (private plus governmental) actually barely dipped during 2008-2009 and began climbing afterward. While low interest rates have suppressed interest costs, the cost of maintaining our debt takes away the ability to spend on newer, more productive assets. In addition, debt represents demand brought forward, so it seems that a lot of future demand was accelerated into previous time periods, meaning current demand was siphoned off earlier and there is less left to impact today's economy. It may be that only a period of slower growth (and possibly higher interest rates) will cause demand to be built up for a future higher growth period. Absent higher productivity (productivity has been relatively tepid for the last few quarters) or cheaper raw materials (drops in energy and many other commodities could help foster growth), growth cannot be expected to rise without some catalysts. Thus, we expect the world to continue its slowing growth trajectory, which if not arrested, will almost

certainly lead to a world-wide recession in 2015, although monetary policy could put this off until 2016 through further monetary stimulus. Financial news "pollyannas" translate rising stock prices into a better economy – however, we don't think this linkage is constant or correct; the markets generally anticipate economic trajectory unless they are affected by other, more powerful factors – in this case, "extreme monetary policy" has robbed the stock market of its forecasting ability.

Equities

Last quarter we presented a bull and bear case for the US stock markets. We believed that there would be enough lynchpins in the 3rd and 4th quarters to determine the short-term direction of the market. It looks as though the "decision" has not been made as traders and investors bought and sold during a very volatile 4th quarter and are still "deciding" the outcome. Thus, we believe the direction is still in doubt, and we have maintained US equity market exposure, balanced with a number of less-correlated positions in which we have more conviction (currencies, bonds, metals).

We believe equities will continue to see more volatility during 2015, akin to the amount seen during the 4th quarter of 2014 where there were three pretty sizeable "pops and drops". While valuation continues to be a real concern (as illustrated in our Third Quarter Letter – high long-term (CAPE) P/E ratios, historically high profit margins, second-highest consolidated market capitalization-to-GDP ratio in history (only behind 2000 dot.com bubble, etc.), it seems that market psychology continues to be the most important driver of US stock markets. The majority of investors still seem to feel that the Fed will come in with monetary support (or the hint of support as voiced by St. Louis Fed President Bullard during the October correction that served to turn around the market), and this engrained view has continued to drive portfolio managers to buy dips, even as we set new all-time highs in stock prices and nearly in valuations.

To help explain why we think this is a very high risk strategy that looks good when new highs are set but could be very dangerous when it is discovered that "the Emperor has no clothes [that monetary easing does not lead to rising prosperity]", we display two turn-of-the-year selections from the economic website ZeroHedge about famous fund manager Hugh Hendry and his large hedge fund Eclectica. His December Letter to Shareholders (as presented on ZeroHedge on 12/31/2014) is titled "Hugh Hendry Embraces The Central-Planning Matrix". We disagree wholeheartedly with Mr. Hendry, but we share his view that many markets, especially US equities, are acting irrationally. Hendry makes the following comments:

> *"There are times when an investor has no choice but to behave as though he believes in things that don't necessarily exist. For us, that means being willing to be long risk assets in the full knowledge of two things: that those assets may have no qualitative support; and second, that this is all going to end painfully. The good news is that mankind clearly has the ability to suspend rational judgment long and often.* ***[Emphasis by the author]***
>
> *"...As I see it, investors have been living in a world in which markets have transcended reality since early 2009. In the first three years - until Draghi's "do whatever it takes" speech in the*

summer of 2012…the role of market Disneyland has increasingly been taken on by the equity and fixed income markets. So the S&P has massively outperformed what has proven to be a tepid recovery in nominal GDP and a global real economy that is beset by deflation; just this month, European swaps contracts began to price in near term deflation. Yet equity markets are ignoring that reality in favour of the idea that the deflationary fall out from the collapse in the oil price will almost certainly mean even more monetary accommodation. The worse the reality of the economy becomes, the more we take on the reflexive belief in further and dramatic monetary expansion and the more attractive the stock market looks.

"What is one to do with such a situation? …I still believe that the attempt by central bankers to prevent the private sector from deleveraging via a non-stop parade of asset price bubbles will end in tears. But I no longer think that anyone can say when. Look back on the last five years and I think that it is indisputable that mass injections of loose monetary policy have both fuelled asset prices and staved off further crisis. I am also absolutely persuaded that the global economy remains so fragile that modern monetary interventions are likely to persist, if not accelerate. They will therefore continue to overwhelm all qualitative factors in determining the course for stock prices in the year ahead.

"So I have come to embrace the French philosopher Baudrillard's insight. 'Truth is what we should rid ourselves of as fast as possible and pass it on to somebody else,' he wrote. 'As with illness, it's the only way to be cured of it. He who hangs on to truth has lost.' The economic truth of today no longer offers me much solace…In the long run we will come to rue the central bank actions of today. But today there is no serious stimulus programme that our Disney markets will not consider to be successful. Markets can be no more long term than politics and we have no recourse but to put up with the environment that gives us; the modern market is effectively Keynesian with an Austrian tail.

"To conclude I thought that I would expand upon our present Platonic thinking on the Chinese equity market. China is set to record its weakest growth in GDP in 25 years. Yet it seems to have entered a bull market and may be where we deploy much more of our risk capital next year. That's because the recent exuberant run up in onshore Chinese equities seems to me to amply demonstrate the power of imagined realities. Earlier this year, the shocking reality of falling property prices across China began to emerge such that even the official Chinese government economic data series had no choice but to admit it was happening. On the assumption that insolvency was all but inevitable international investors (Eclectica amongst them) began to fear a surge in bad debts at the major Chinese banks and sold. Financial stocks took a beating and the major banks started to trade at a steep discount to their reported book value.

"At this point, the situation in Chinese capital markets began to resemble that of Europe back in the summer of 2012 when Spanish and Italian government bond yields came to exceed 6%. The capital markets were effectively betting on the ECB failing to contain the crisis. With Spanish and Italian government bonds now trading below 2%, this has proven a bad bet… [Q]ualitative truth factors such as enduringly weak economic growth, political backsliding on

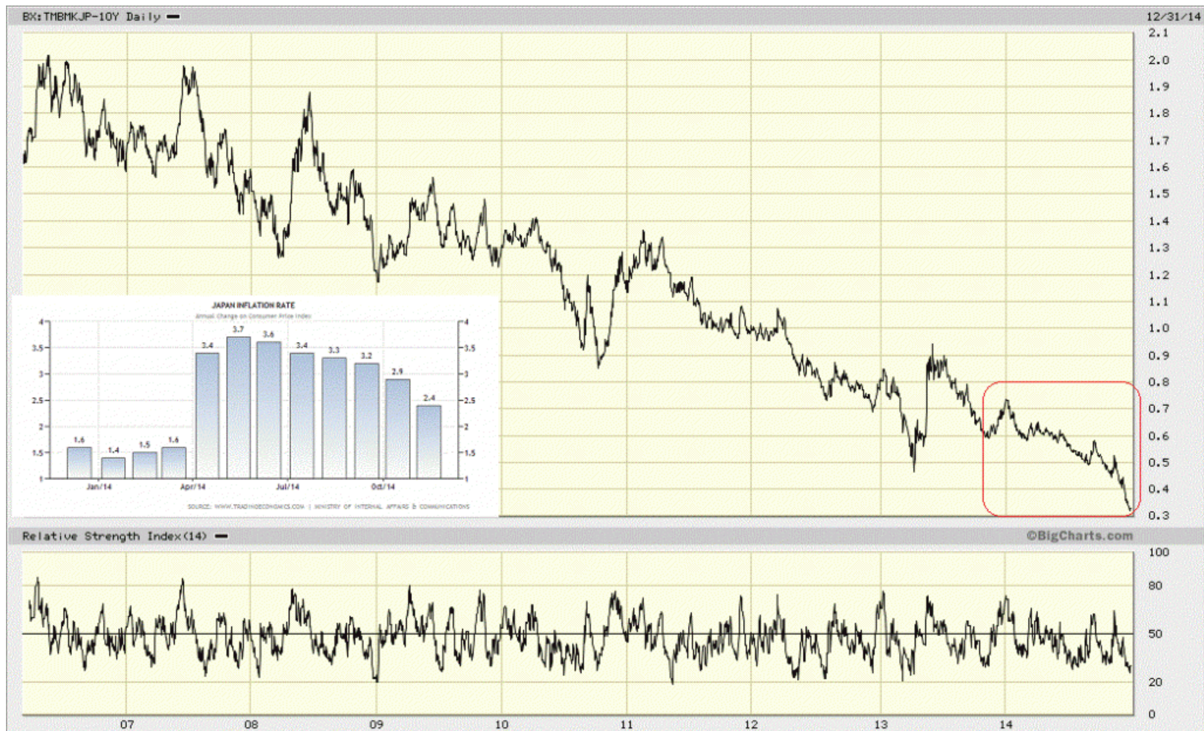
structural improvements and a systematic failure to control the size of fiscal deficits [seem to doom the Eurozone]; despite all this the market has relentlessly ground higher on the basis of the imagined reality that the ECB will overcome all institutional objections to the contrary and will buy sovereign European bonds en masse…"

ZeroHedge proceeded to post a commentary on Hendry's letter by Pater Tenebrarum (via Acting-Man blog) on 1/2/2015. Mr. Tenebrarum has some excellent points:

"We have always liked Eclectica fund manager Hugh Hendry for his sound views and outspoken manner…Mr. Hendry runs the Eclectica Fund and in recent quarters has frequently stressed that being contrarian has been a losing bet over the past few years … while investors and fund managers relying blindly on the "money illusion" provided by central bank interventions have done quite well.

"This is undeniably true. *A prime example of what absurdities have become possible is shown below. The chart shows the 10-year JGB yield; Japan's monthly annualized CPI rate of change over the past year is also shown, as an inset in the chart. The red rectangle outlines the time period over which these CPI readings were reported. At no point over the past year was Japan's CPI not <u>at least more than twice as high</u> as the 10-year JGB yield. Even if one disregards the fact that CPI has been boosted due to a sales tax hike in April, current JGB yields make no sense. Prior to the sales tax hike, CPI fluctuated between 1.4% to 1.6% annualized, or 1.5% on average. This would still be almost five times the current 10-year yield of 0.31%.*

"In past 'reflation' attempts by the Bank of Japan (BoJ), investors tended to drive up JGB yields concurrently with stock prices. Reported CPI figures also happened to increase slightly on these occasions. Investors consequently demanded higher yields. However, nowadays the BoJ has "become the JGB market". It is such a big buyer, that no-one dares to oppose it anymore. After all, it has theoretically unlimited amounts of money at its disposal, since it creates them with the push of a button. Trading volume in the JGB market has completely dried up. Shorting JGBs is still the 'widow-maker trade' – for now, anyway.



10 year JGB yields since 2006 and Japan's CPI rate of change over the past year (the period corresponding to the red rectangle)

"We are mentioning all this not to pick specifically on Japan's policy makers (most others are by no means better), but mainly to confirm that Hugh Hendry does have a point. The prices of financial assets have been and continue to be massively distorted by loose monetary policy, and fighting these trends, no matter how absurd they appeared, has hitherto been a losing game.

"[However, w]e believe that there is a grave danger associated with [Mr. Hendry's strategy]... To see how dangerous overvalued and extremely stretched markets can be, ***one only needs to study how prices have behaved following previous major historic peaks. The initial downturn is never seen as a cause for alarm. Sometimes this can however be followed by a decline so swift that having a tolerance for drawdowns can end up leaving one with very big losses in a very short time period. [Emphasis ours – KS]***

"Such sudden reassessments of market valuation can rarely be tied to specific fundamental developments. Rather, anything that is reported is all of a sudden interpreted negatively and becomes a trigger for more selling, even though similar news would have been shrugged off a few days or weeks earlier. After all, nearly every economic news item can be interpreted in a number of different ways, so that even superficially good news can become a problem (in the current situation they could e.g. create fears of a faster tightening of monetary policy).

"[One example is the Rydex family of mutual funds] … Rydex bear fund assets have ended the year right at an all time low, while the bull-bear asset ratio has continued to soar in

blow-off like fashion. Remarkably, the ratio has moved from a level just below 12 at the low of the October correction to a high of nearly 30, in spite of the market not making a great deal of headway above its September peak…*We were recently asked whether Rydex ratios are still meaningful nowadays. Although the assets invested in these funds are very small relative to the market's size, we believe the data are akin to those gathered in political polls: the replies of a few thousand people can deliver statistically quite meaningful results applicable to the population at large. Similarly, the positioning of Rydex traders does tell us something meaningful about general market sentiment.* ***[Emphasis by the author]***

"The most recent development strikes us as actually especially meaningful. Bullish positioning has taken off like a rocket in the last quarter from an already high level (bull and sector assets rose by nearly 40%), while battered bear assets have plunged nearly by another 40% in just the final ten weeks of the year. The last quarter is especially noteworthy, as a massive surge in the bull-bear ratio occurred while the SPX gained only 70 points relative to its September peak. ***Comparing the two data points peak-to-peak, the SPX rose from about 2,020 at the September peak to 2,090 at the December peak (a gain of 70 points or 3.47%) while the Rydex asset ratio rose from approximately 18 points to 29.81 points over the same stretch (a gain of 11.81 points, or 65.6%). From its October low the ratio notched a gain of nearly 153%. In short, there is quite a big divergence between the actual gains delivered by the market at year end and the extent of conviction regarding further gains expressed by the positioning of Rydex traders. [Emphasis ours – KS]***

"We will readily admit that one cannot know with certainty whether the bubble in risk assets will become bigger. However, it seems to us that avoiding a big drawdown may actually be more important than gunning for whatever gains remain. One can of course endeavor to do both, but that inevitably limits short term returns due to the cost of insuring against a potential calamity.

"We don't know what, if any, insurance the Eclectica fund has in place, or whether Hugh Hendry's trader instincts will help him to sidestep the eventual denouement; we are certainly hoping so and are wishing him all the best. However, we don't think it is a good idea to simply [suspend disbelief] and rely on the idea that the effects of the money illusion will last a lot longer. It is possible, but it becomes less and less likely the higher asset prices go and the more money supply growth slows down.

"Lastly, the crude oil market strikes us as quite a pertinent example in this context, because everything that is these days mentioned as a cause of its enormous decline (such as the economic slowdown in China and Europe and the greater supply due to fracking) was already known many months before the sell-off started. The only thing that actually changed were market perceptions. No market is magically immune against such a change in perceptions."

We believe these two pieces do an excellent job of presenting the nearly-insane belief that central banks and monetary policy will continue to propel asset markets higher. Lower-risk holdings, while possibly continuing to underperform in the short-run, will preserve wealth when asset prices

eventually re-establish historical equilibria and lots of illusory wealth disappears, and recent underperformers regain acceptance in investment portfolios.

There are two other selections we have read lately that we believe help with our insights about US equity markets and the decisions on short-term and long-term. The first is an observation from John Hussman's 1/12/2015 Comment titled *A Better Lesson than "This Time is Different"* that helps interpret some of our thoughts about the stock market and the reason that it has held up so well through 2014:

> *"If one wishes to share what we've learned from our experience, without dispensing of the benefits that we've demonstrated from this historically-informed, value-conscious, risk-managed discipline in prior cycles, the key lesson is this:* ***The near-term outcome of speculative, overvalued markets is conditional on investor preferences toward risk-seeking or risk-aversion, and those preferences can be largely inferred from observable market internals and credit spreads. The difference between an overvalued market that becomes more overvalued, and an overvalued market that crashes, has little to do with the level of valuation and everything to do with investor risk preferences. Yet long-term investment outcomes remain chiefly defined by those valuations [Emphasis by the author].***

Fred Hickey, in his 1/4/2015 The High-Tech Strategist titled *Running on Fumes*, details some of the extent of today's historically high valuation in US stocks:

> *"…Though stock market corrections (10% or more) typically occur on average about once a year, there hasn't been a correction since October 2011. That's 3 ¼ years and counting. Last year the S&P 500 index never fell for more than three consecutive days. That's never happened in any year before – at least since S&P launched its first index nearly 90 years ago.*
>
> *"…The market's price-to-sales ratio is at an all-time high, the market capitalization to GDP ratio (Warren Buffet's favorite indicator)* ***[and illustrated in our letter last quarter – KS]*** *is the second highest in history and the price to earnings ratio – any way you want to calculate it – is dangerously high. The Shiller Cyclically Adjusted P/E Ratio for the S&P 500 is 27. That level has been exceeded only two times before – in 1929 and 2000 – just prior to those two epic crashes (the Shiller P/E ratio was also 27 at the market top in September 2007). The 1929 market topped out at a 30 P/E. Put another way – all the dozens of other bear markets (except the three noted) that have occurred over the past 135 years began with Shiller P/E ratios at levels lower than today. The median P/E over this period is 16. Even the "trailing" P/E (not cyclically adjusted) using today's inflated earnings numbers (stock buybacks and other financial engineering) is 20 for the S&P 500 and is far higher than the historical average (15)."*

Thus, we at Kanos will maintain our stance of running a risk-adjusted portfolio with equity, currency, fixed income and commodity-oriented positions, adding shorter-term US equity exposure when US markets poise for further advances, while reducing this exposure when our analysis determines a number of indicators of weakness.

Precious Metals

Precious metals prices and miners' stocks started out 2014 with a bang and stayed positive most of the year until the market convinced itself that the end of quantitative easing in October caused only a minor correction (S&P 500 down less than 10% and recovered rapidly) and that the Fed would raise rates in early-to-mid-2015 due to a moderately growing US economy and falling unemployment. By year's end, gold sentiment was back to "black bearish", with the Hulbert Gold Newsletter Sentiment Index at a very low -47% level and the Gold Miners Bullish Percent Index at 0% (lowest possible) [hat tip to Fred Hickey for those statistics]. In addition, the Gold Stock Analyst rates the valuation of mining companies to **be at a 55% discount to fair value**, based purely on post-2008 valuation methodologies. Thus, valuations and sentiment are rock-bottom, and we believe the underlying fundamentals are actually improving and prices are rebounding (see below).

Most importantly, the US economy does not seem to be growing. Economic measures were skewed by high 3rd quarter spending by the US Government in front of midterm elections. Thus, as future economic statistics show slowing growth, we believe that not only will the Fed not raise rates in 2015, but it will probably become more accommodative, which could mean more QE. This will be bullish for gold. Already in mid-January, we are seeing this sea change in economic results and sentiment: wage levels in December payrolls (announced January 9th) **fell 0.2%** (expected to be up 0.2%), retail sales for December (less volatile auto and gasoline sales) **fell 0.3%** (announced January 14th and thought to rise 0.6%!) and the Gold Miners ETF was by far the best performer in the US markets through the first two weeks of January – **up 12.15%** already. Second, the rout in energy prices is a plus for the mining business. Energy is generally considered to be 10-30% of the costs of a mine (depending on the type of mine and the geography of the location), meaning costs should fall dramatically over the next year and give a boost to profitability. Finally, a big cloud hanging over the precious metals complex has been the "invincibility of central banks" and the "Fed put" psychology. As the US economic growth story fades, and the Fed's inability to engineer a self-sustaining recovery is revealed, robotic "buy the dip" mentality in the equity markets will wane as investors look for more traditional safe haven vehicles like precious metals ETFs and mining stocks. In addition, expected monetary easing by the ECB in late January should provide even more of a "tailwind" for the metals as the euro continues to fall in value, and Europeans look for wealth preservation alternatives to their currency. We continue to believe that overweighting this sector will yield large benefits in 2015 and beyond.

Energy

Energy is a different story than precious metals. While crude oil and its products are the lifeblood of worldwide economies, the combination of slowing worldwide demand growth, high supply levels and bearish psychology will continue to keep oil and products levels far below the levels of mid-2014. We believe the power of financial trading will push the price of WTI crude oil into the $30s/bbl, forcing marginal producers to stop drilling plans and possibly curtail production that would be produced at a "cash basis" loss. Only when we see crude trade down in that last gasp fall, and we see actual production shut-offs, will the crude price be on the road to recovery. There are some bargains

in the oil sector that we are examining, but we believe the drop into the $30s/bbl will "cause the last shoe to drop" and allow for buying selected stocks at even better prices. The complicating factor of the large debt loads of many producers will make selection of winners and losers among US independents particularly difficult. Buying the debt of some producers might be a better risk/reward situation than the equity.

Natural gas supplies have benefitted from domestic high crude oil production and improving drilling and completion technology. However, these higher production yields have had their effect on prices, with even a moderately cold US winter not able to arrest price drops from an adequate overall supply situation. Thus, we believe that, absent a sustained January-February series of polar vortexes, US natural gas prices will stay low, albeit with volatility during cold snaps, and could fall further into the 2nd quarter when winter weather ebbs and supplies still in storage determine natgas buying patterns for the rest of the year.

There is one caveat to our crude oil price analysis: if the Fed comes back into the market and eases monetary policy/increases US dollar supplies significantly, we believe there could be an inflationary reaction to easing monetary policy worldwide (since Asian central banks are already easy and getting easier and the ECB is widely expected to begin QE in late January). This could send crude oil prices back up again – albeit to a range of $50s-60s/bbl in the short-term until supply growth is arrested or declines due to curtailed drilling and natural depletion.

Bonds

Since we believe US economic growth is slowing, we have been buying Treasuries for Kanos portfolios to capture some yield and believe we will also realize capital appreciation. As weakening US economic growth becomes apparent, and anemic growth (at best) or recession continues in much of the rest of the world's economies, we believe more and more investors will start to embrace long-term US Treasury bonds as their "go-to" investment for new flows/redeployment due to their safety, relative yield, and their favorable demand/supply dynamics (the Fed owns a large amount of these Treasuries, as do China and Japan, who are unlikely to unload them in this environment [and, in fact, may buy more to further weaken their currencies – certainly Japan and possibly China]). Thus, we see long-term Treasury rates dropping and agree with widely-followed bond "guru" Jeff Gundlach that rates could challenge the 1.00% level for the 10-year (incidentally taking out the 1.40% low reached in May 2013). How could that happen? The slowing economies of Europe and Asia provide a clue: Japan's 10-year bond yield as of this writing is 0.24% (yes, that low); Germany's 10-year bond yield is 0.46%, France's 10-year yield is 0.72%, Britain's 10-year yield is 1.52% (and their growth is expected to be on the order of the growth in the US), Spain's 10-year yield is 1.64% (the country is nearly an economic basket case) and Italy's 10-year is 1.81% (the country is an economic basket case) – **all lower than the US 10-year Treasury that is currently trading at 1.83%.** To further the point, the 30-year Treasury is at an all-time historical low of 2.43%, and the German 5-yr yield is -0.01% (yes, a negative yield, where investors are so worried about return of principal that they are willing to take back less at maturity than they invested). The Japanese 5-yr is also at -0.01%, with the same mentality of the German 5-yr; safety beats any yield.

However, corporates and high yield are in different straits. Corporates, especially high-quality balance sheet corporates, should move down in yield like government bonds – providing some safety but little yield. High-yield (HY) bonds, which have "coat-tailed" government bond yields to near-record low yields this fall have now found that risk looms larger than in the past – energy bonds, especially of lower-quality balance sheet companies, have lost a lot of value as prospects for interest and principal payments become a serious issue with the drop in energy prices. We believe investors will continue to bifurcate the HY market, shunning poorer credits like energy companies (possibly leading to even lower prices as some energy companies declare bankruptcy) while chasing yield and taking on the risk of "non-tainted" sector bonds, although we think this may end up being a poor risk/reward tradeoff.

Other Markets

Our highest conviction longer-term trades continue to be shorting the Japanese yen and, to a lesser extent, the euro. We believe that the success of Abenomics in Japan, powered by lower and lower interest rates (through the Bank of Japan buying bonds) coupled with BOJ buying of equities (along with the large GPIF pension fund mentioned above), will hinge on keeping the yen exchange rate with major partners (especially trade denominated in the US dollar) low and pushing it lower to try to make Japan the most competitive supplier of industrial and manufactured products to the world. This "mandate" will continue to lead Japanese authorities to take any and all opportunities to weaken the yen. Thus we will stay short the yen until the reasons around the trade either terminate due to policy changes or if the risk/reward changes to be unfavorable.

We believe the euro is as certain to drop in value as the yen. A growing number of European authorities see it as being favorable to have a lower euro, especially in light of lower energy prices (at least in US dollar terms). With virtually all of Europe (including Germany) either in or approaching recession, we believe the ECB will have to be more and more easy with monetary policy, whether that means instituting quantitative easing in late January or resorting to other types of policy to try to ease monetary conditions. Such a program has only been held back by German/Dutch/Austrian opposition to outright buying of bonds by the ECB but that opposition seems to be at an end.

Regardless of how ECB easing is instituted, we are unsure of how the future of the euro will turn out; this we see as the real limit on maxing out our short euro position. If countries start to leave the euro (which we see as inevitable – first Greece, then certainly followed by Portugal and possibly by Spain, Italy and some of the eastern European countries), will the euro become stronger because it will essentially be transformed into a northern European euro (and considered a de facto German Mark)? If so, the euro will strengthen rapidly at some point in the future. If however, the architects of the euro, namely Germany and France, refuse to let countries leave the euro and continue the status quo of keeping them on life support, then the euro will continue to drop in the future as the "sick countries of southern Europe" sap more and more of the economic vitality of the area. Stay tuned – we believe the second scenario will occur first, dropping the euro and sapping the area further, which will then inevitably lead to the first scenario – countries leaving and causing the European Union to become smaller and stronger. This will certainly be a multi-year process.

Kanos Quarterly Commentary

Interview with the Portfolio Manager

We have periodically had a section where our portfolio manager answered questions about the financial markets and your portfolio. We thought this would be a good time to have another session of Q&A, especially in light of how the markets have acted over the past few months.

Q: What is your view on the US stock market these days?
A: As related above, we are cautious on the US stock market due to valuations and the length and weak underpinnings of this current bull market. We continue to maintain US equity exposure but emphasize lower valuation situations and balance portfolios with attractive currency, fixed income and certain commodity-oriented positions.

Q: What worries you most these days?
A: We have remained only cautiously bullish in this market because equity market valuations and some concerning market divergences. A relatively small group of large-cap stocks have provided most of the gains in the market this year, while the majority of the stock market has had a flat or poor year – the Russell 2000 index of the 2000 largest stocks in the US peaked on July 3rd and only matched that level in late December after a huge late-year run. Energy stocks have been destroyed with the 2nd half drop off in the crude price. High-yield bond spreads have widened, indicating concern over credit quality. The advance-decline line in US stocks has flattened out after mirroring the S&P 500 over the last couple of years, indicating falling stock market momentum. Lately, volume has been lower on 'up' days in the market and higher on 'down' days. Coupling all of these reasons with high equity valuations, which have only been higher during the 1999-2000 dot-com bubble, and the 2nd half of 2014 weakness in junk bonds, the market seems vulnerable to a big pullback at some point in the near future.

Q: Is there anything that could change your mind?
A: Yes – signs of economic recovery in recently weak sectors propelling markets higher would convince us to be more aggressive in the market. Also, if the Federal Reserve reversed their tightening language, we believe there would be a large rally. Finally, we believe that if the ECB finally embarks on a quantitative easing program that is larger than the market expects, we can see stock markets rallying further.

Q: Those sound like short-term catalysts for a higher market. Would any of the things listed above lead to a sustained new leg to the bull market?
A: We are not sure there is a good catalyst, absent a new round of US QE, because the US economy appears to be "bumping along" at best. In addition, in our minds, market analysts are misusing standard tools to measure stock market valuations during extreme conditions. With interest rates at historic lows (500 year lows in Germany and the Netherlands according to Deutsche Bank via The Financial Times) and wage rates currently putting little pressure on corporate profits, investors have convinced themselves that historically high profit margins are not going to revert to the mean (even though they always have throughout US economic history). We have a hard time buying into the

notion that stocks aren't overvalued "since they are still below 1999-2000 valuations" as many market strategists argue. Today's valuations are predicated on historically low interest rates, historically high profit margins and real wages that haven't increased in approximately 15 years; that just appears unsustainable to us.

Q: So bottom line, do you think there will be a rally in 2015?
A: While we think the bull market is old and tired, we also believe that investors have gotten so used to climbing stock prices that there is a better-than-average chance that stock prices could rise further in 2015. A couple of big reasons come to mind: first, the vast majority of active fund managers (including ourselves) have not matched market returns in 2013 and 2014, and many managers see this as a reason to increase beta (exposure to markets) substantially to make up for recent underperformance. [We see this as dangerous for our clients' portfolios and don't follow this strategy]. A second reason is that there are favorable historical precedents for the third year of presidential terms and for years ending in the numeral '5'; again, we don't practice such market following strategies but monitor them. Finally, portfolio managers continue to follow their recent practice of extreme trend-following and buying after **any** corrections in market levels. We have a hard time overweighting market allocations when markets have been setting new highs on stretched valuations and divergent internal indicators in the markets.

Q: Ok, you sound like you continue to follow your historical examples and valuation analysis. What would you say is a more surprising part of your current market view?
A: That we are constructive on long-term US Treasuries. A few analysts we follow believe worldwide growth has slowed enough that inflation has truly flattened out during the summer/fall of 2014. Thus, they believe investors will be moving further toward the yield (albeit small yield) and stability of government bonds during 2015 as economies prove difficult to stimulate through mostly monetary policy. Thus, we have moved up the safety curve and out the yield curve, buying long-term US Treasury ETFs to gain yield, protect capital and make some capital gains. Long-term Treasuries had a total return of almost 25% last year when rates on the 10-year moved from 2.973% to 2.174%; those yields have already dropped to 1.85% in mid-January, so the positions continue to work for us.

Q: How low could US ten-year Treasury bond rates go? They are already very low at around 1.85% (in mid-January).
A: We don't really know how low they can go, but as related above, bond "guru" Jeff Gundlach went on record in November as saying he thought they could go to 1%. That is a long way down. We are not sure they will fall to that level, but we do believe they should converge with extremely low European 10-year rates, which are at amazingly low yields as of late December: Germany at 0.46%, France at 0.72%, Spain at 1.64%, Italy at 1.81%, Switzerland at 0.22%, the Netherlands at 0.68% and even Portugal at only 2.69%. With Japan at 0.32%, Hong Kong at 1.88% and Canada at 1.91%, US Treasuries seem like they can attract a lot of capital, pushing rates potentially quite a bit lower. If I have to make a prediction, I think that we will eclipse 2013's low of 1.40% and maybe can fall below 1.25% on the 10-year. One last factor: speculators in the US futures markets are still betting on **higher** rates (on balance) for 10-year Treasuries in bond futures (as of mid-January), so if traders are forced to cover these positions as rates drop further, they could push yields down further than we expect (similar to October's "bond flash crash" in October referenced above).

Q: What changes have happened around Kanos Capital Management in the last few months?
A: In the past few months, we at Kanos have expanded our research methodology to provide better insight and advice to you, our customer.

Q: Can you tell us a little more about your expanded research methodology?
A: Yes, our methodology has evolved as we absorb the actions in a larger spectrum of financial markets. For the most part, we examine the macroeconomic environment in the US, Europe, east Asia (mostly China and Japan) and to a lesser extent Latin America and the rest of Asia. We try to find (and examine for longevity) investment themes that we believe will last years, and try to figure out the best way to take advantage of these opportunities. We have expanded our processes to better analyze world equity, fixed income, currencies and commodity markets, emphasizing portfolio diversifications and macro scenario analysis. We then try to identify sectors that will benefit, and then we try to find individual stocks, funds or bonds that are attractive fundamentally to examine further. If we like the numbers, management and technical analysis of the security, we will look to buy it for portfolios. In addition, we frequently screen for cheap stocks, examining the fundamentals, technicals, price action and reason for valuation to see if they should be added to portfolios. Finally, we look at technical studies periodically to help us judge where we are in market cycles, and whether price action is signaling for us to make a change in portfolios or individual stocks/bonds/funds/currencies.

Q: What research do you read to help you determine your investment thoughts and eventual investment decisions?
A: We try to read diverse authors, research sources and economic articles that give us what we hope is a balanced view of markets. This means that we are attracted to people we consider “truthers”, who tend to see and comment on the financial markets dispassionately. We see this in contrast to many “sell side” analysts at large investment houses who many times put out research that justifies the firm’s support of companies, rather than being objective and rating researched companies “sells” when they feel that companies are falling short of expectations or just doing badly.

To be more specific, we read articles on websites such as Bloomberg, The Wall Street Journal, Yahoo Finance and Forbes, but we also read ZeroHedge and follow Twitter feeds from a number of financial pundits. In addition, we buy investment research from investment newsletters as well as specialized investment services on certain sectors in the markets, including precious metals and bonds.

Q: Have you changed your methodology?
A: No, we have added to our processes to better evaluate investment opportunities and risks. In addition, when we have felt that the markets were rising at a time when we had less market exposure in our portfolios, we have hedged portfolios by adding long-market index hedges as a way to gain market neutral exposure while keeping conservative stock picking as the basis for the majority of our equity exposure.

The Managers of Kanos Capital Management
© 2015 by Kanos Capital Management, LLC All rights reserved.