KANOS
CAPITAL MANAGEMENT, LLC

Second Quarter 2015 Investor Letter

Portfolio Comments

The second quarter was characterized by a lot of up-and-down movements in markets due to the evolving situation with Greece and the EU as well as the gradual weakening of the US dollar after such a strong first quarter.

In portfolios, we added some small new positions but generally did not adjust asset allocations significantly, waiting for better signs about the way stock prices would move in the future.

We would like to comment additionally about our overall portfolio construction and going-forward strategy. We continue to pursue what we think of as a "barbell" strategy: most of our portfolio in value-oriented large-cap stocks (with Treasuries as a hedge) along with currency, international equity and resource positions while we have added a higher-risk component in recent quarters to participate more fully in equity market movements. We believe that having a right-sized speculative piece of the portfolio will give us a market-type return component that has been lacking in our value portfolios during this growth mania. However, these "higher beta" components are carefully chosen, and we will stay with them until we believe markets will enter a sustained down-phase, after which we will lighten up specifically in these more speculative positions (at a time when we believe our value positions will outperform).

Second Quarter Market Conditions

April was a month where many markets corrected from some extreme moves earlier in the year. Leading gainers in the financial markets were the price of crude oil, both WTI and Brent, which rose approximately 25% and 20% respectively. Chinese equities were the biggest winners worldwide, with the Shanghai composite rising almost 20% and Hong Kong's Hang Seng index rising 13%. The S&P 500 returned just 0.96% (up 1.92% YTD), led by the Energy, Telecom, Technology and Materials sectors. The Healthcare, Consumer Staples and Utilities sectors were down during the month. Treasury bonds also dropped during the month, with 10-year yields closing at 2.046%. European bonds dropped from their extremely high levels of March, led lower by British Gilts, German bunds and Spanish sovereign bonds. US and European corporate bonds were also lower on the month. Commodities managed a bounce during the month, with the CRB index rising about 8% and copper rising 5%, although grains, led by wheat (-8.7%) and corn (-3.3%) were weaker. Gold was roughly flat for the month. In currencies, the US dollar finally corrected its strong rise, led by the euro which was up 5% against the dollar. The yen/dollar rate was roughly unchanged for the month.

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May brought a bit of a return to past themes, led by the advance of Asian equity markets. Japan's Nikkei led gainers during May, showing a return of 5.3%, while China's Shanghai Composite was up another 4%, taking its gains to 42% for the year. European bourses were mostly stronger, led by Italy's FTSE-MIB up 3.6% (up nearly 25% YTD), Greece's Athex up 2% and Britain's FTSE-100 up just under 1%. The S&P 500 was up 1.29% (total return) for May, led by advancing sectors Healthcare (up almost 5%), Technology and Financials. Lagging sectors were Energy (down nearly 5%) and Telecoms. The big losers for the month were Emerging Markets, led by a 6% drop in Brazil's Bovespa and a 4% drop in Russia's Micex index, and the broad MSCI Emerging Markets Equity Index was down almost 4% for the month, and EM bonds were also down almost 2%. This reaction was at least partially due to an again-rising US dollar, which gained another 4% on the yen and 2% on the euro. Developed world bonds were volatile but traded in a range, with British gilts the best performers and German bunds the worst, but monthly gains/losses were generally 1% or less for bonds around the world, governmental or corporate. Silver gained 4% during May, while gold gained 0.91%. Losers in commodities were copper (down 5%), Brent crude oil and corn (both down almost 3%) although WTI was up 1%.

In June, US equities see-sawed with daily machinations in the Greece/EU negotiations and mixed economic reports, both domestic and international. The S&P 500 was down 1.94% for the month, with Consumer Discretionary the only sector to gain in June. Sector losers included Utilities, Technology, Materials and Energy. Many international indices were also down: China's Shanghai and Hong Kong's Hang Seng, down 7% and 3%, respectively, led the downside movers. European stock markets were mostly down in the 2-4% range during June. Brazil's Bovespa and Japan's Nikkei stock indices were the winners, up 3% and 2%. Most bonds ended the month roughly unchanged, as did most of the developed country currencies. The big winners for the month were wheat and corn, both rebounding after weakness earlier in the year. Silver and Brent crude oil were the commodity losers, down 6% and 5%, respectively; gold lost just over 1% for June.

Equities

For the quarter, the S&P 500 was actually down 0.23%, ending at 2063.11, although with dividends included, the total return was a positive 0.28% (the Dow Jones Industrials were down 0.9% for the quarter). Uncertainty over global macroeconomic machinations as well as concerns about slowing earnings caused US equity indices to stall; sectors, however, were much more diverse in returns: Healthcare, Consumer Discretionary, Financial and Telecom sectors gained while Utilities, Industrials and Energy were the biggest losers. In worldwide equities, the quarter showed far more gains than in US stocks, although a losing June cut quarterly gains for many European indices. Germany's DAX (+9.3%), France's CAC (+12.3%), Italy's MIB (+19.0%) and Spain's IBEX (+4.8%) all gained during the quarter (although all suffered losses in June). Most smaller European bourses were up strongly also, with gains of 26.6% in Denmark to +6.8% for Sweden. Asian indices performed well again during the quarter; Japan's Nikkei gained 15.0%, China's Shanghai gain 12.7% and South Korea's KOSPI advanced 7.9%. Underperformers were smaller markets in Eastern Europe, Middle East and Latin America (Greece -10.2%, Bulgaria -11.9%, Egypt -6.1%, Columbia -9.7%, etc.). European QE failed to keep smaller stock markets buoyant as investors worried about the Greek financial situation and possible side-effects that it could cause in other small countries considered risky.

Precious Metals

Precious metals prices eased lower over the quarter as low volatility in the stock market and slightly improving economic conditions, helped by the short-term effects of quantitative easing in Europe and the inevitability of a Greek compromise, drove investors back toward risk investing. However, gold mining shares enjoyed a good quarter, rising in the face of flat or falling precious metals prices, as investors recognized better company operations and results and growing (but nascent) inflation concerns, although a late June sell-off drove prices more towards unchanged for the quarter. Gold ended up down 0.98% for the quarter, ending at $1,171.50/oz. Silver was down 5.9%, settling at $15.66/oz. Interestingly, the precious metals were down much in lockstep with the falling US dollar, showing their growing commonality as safe haven investments.

Energy

As chronicled above, WTI crude oil had a “gangbusters” April, rising above $60/bbl, but then basically vacillated to end virtually unchanged from its April close. WTI closed June at 59.47/bbl, up 24.9% for the quarter. Brent crude oil, while also having a very good April, slid in price for much of the rest of the quarter as growing OPEC supplies (mostly Iraqi and Saudi gains) impacted the worldwide supply/demand balance that Brent crude best represents. In addition, the amount of crude oil stored in the United States continued to climb during the quarter, leaving inventories approximately 130 million barrels over its five-year average, which is 10.5% higher than average. At this pace, US storage could exceed its all-time high of 1.87 billion barrels, which is one reason we are unsure that oil prices stay as high as they currently are. Natural gas, after rallying strongly during May to reach a high of $3.10/MMBtu on summer heat concerns, fell again during late May/early June and closed at $2.83/MMBtu, up only 7.3% for the quarter.

Bonds

After rallying to multi-year highs in February, longer-term Treasury bonds continued to correct during the second quarter, with yields rising above the 2014 close at 2.173% in late April and continuing higher for the rest of the quarter. The 10-year Treasury yield ended June at 2.335% (up from 1.93% at the end of the first quarter). All long-term Treasury bonds suffered during the quarter as bond investors looked for higher yields, selling Treasuries for high-yield corporates (which ended down only 2% for the quarter). Another reason Treasury bonds were weaker was the panic trade from Europe reversed, with Europeans selling lots of sovereign bonds (US Treasuries as well as European governments) as investors were willing to take more risk by buying corporate bonds. German Bunds and other European sovereign bond prices dropped even further than US Treasuries, best represented by their rising yields: German 10-year bund yields rose from approximately 5 basis points (0.0005%) in March to 95 basis points (0.0095%) in early June, before settling down to 0.7415% at the end of the quarter. With much of the "action" in stocks, currencies and the "Greek drama" during the quarter, US and European bond markets, except for the sovereigns discussed above, were less newsworthy than in previous quarters, and price action was relatively muted. US high yield bonds generally followed US stocks, staying relatively flat in price in April and May but swooning in June.

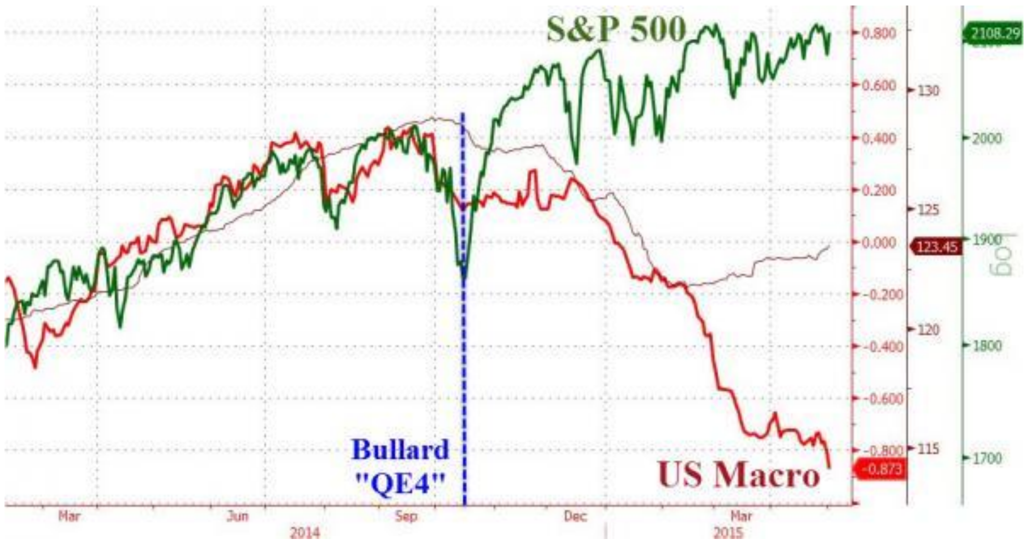
Other Markets

Currencies were varied during the quarter. The US dollar weakened through much of the quarter, primarily versus the euro, which rebounded from a low of 1.05/$ to trade between 1.11 and 1.15 for most of the quarter. The euro ended June at 1.1141/$ at the lower end of its June trading range. The Japanese yen, on the other hand, was steady to the dollar through mid-May and then fell to new multi-year lows, above 125/$ before rebounding to a range around 123/$ (closing June at 122.50). Other currencies were mostly weaker toward the dollar (like the Mexican peso, Canadian dollar and Australian and New Zealand dollars).

Going Forward

Economy

While the US economy definitely rebounded from weakness in the first quarter (final level of GDP was a -0.2% contraction), economic growth was very uneven. Most market analysts have focused on a couple of indicators: 1) jobs & jobless claims (good, but generally considered lagging indicators of economic strength), 2) business activity surveys (services, good but manufacturing weak; these are considered coincident indicators), 3) consumer spending reports (flat-to-down most of the year, with a small rebound in the late spring, a bit of a leading indicator), and 4) regional economic surveys (mostly anemic growth or slight weakness, but these are leading indicators). We are concerned that the weakness of the economy and the past strength in equities are creating a dichotomy that will be resolved sometime soon. This dichotomy is best represented by a graph from ZeroHedge from their May 7, 2015 post "US Macro Data Has Never Collapsed This Fast":



The macro data released since mid-May has improved slightly, meaning the red line above would have flattened out by the end of June, but the graph shows that the Fed is really caught: they want to raise rates because they don't want to: 1) have a recession start with interest rates at 0% which would require them to resort to more "unconventional" monetary policy like "QE4" suggested by St. Louis Fed President Jim Bullard [and indicated above on the graph, showing that his comments stopped the stock market drop and launched it on its latest "bull leg"), or 2) raise rates when the US economy is still weak and have the economy weaken and possibly contribute to financial markets dropping significantly, which would then be "blamed" on the Fed for "causing" the weakening in the economy and markets. In addition, the PCE (personal consumption expenditures) measure of inflation, which is the Fed's preferred inflation gauge, registered in late June year-over-year growth of only 0.2%, with the core PCE reading at 1.2% due to the exclusion of energy. This reading is low enough that there are voices on the Fed arguing for continued easy money until inflation gets to or above the Fed's 2.0% target "for an extended period of time."

Thus, until we see many more indicators of the economy showing strength, and/or we see indicators of "core" inflation showing readings above 2.3-2.5% for a number of months, we believe the Fed will "talk a good game" but refrain from raising interest rates. If the much-anticipated economic rebound expected in the second half of 2015 does not materialize, we think there is even less of a chance that the Fed raises rates before 2017 so as not to manipulate the economy during the "all-important" presidential primaries and elections of November 2016.

Equities

Although we think the economy will continue to sputter as described above, we believe US equity markets will remain resilient, at least through the summer. First, since the Fed did not raise rates in June and won't do so before September at the earliest, we believe the "fuel" of 0% interest rates and easy lending standards will continue to allow companies to finance at low rates, buyback stock with money raised in the bond market, and allow acquisitions to be done at extremely low financial costs. These three factors, while generally considered “late cycle” indicators in a bull market, have generally in the past helped aging bull markets continue their rise. QE programs in Europe, Japan and China also help drive capital toward the US, meaning on-balance, capital should be entering the US and going into stocks since they are at near-historically low volatility and many S&P 500 stocks pay dividends substantially higher than any developed country government bonds.

However, we are very concerned about the September/October timeframe when third quarter results will be finalized and announced, signaling whether corporate profits have rebounded or not. 2015’s first quarter results and expected second quarter results show a year-over-year decline versus 2014, an occurrence not seen since 2009. If the strong dollar and a petering-out economy take their toll on corporate profits, we believe the US equity markets (and thus probably many of the world’s equity markets) will have their first 10%+ corrections since 2011. With such a large timespan since their last real correction (the third longest in history after two stretches in the 1990s), any correction could happen suddenly and violently (like October 2014’s “near correction”). Psychology has been strong in the stock market for years (referenced in last quarter’s commentary), and we believe that psychology could stay strong, but in a less stable version than earlier in the bull market.

We thought a late-May 2015 interview with Robert Shiller (Yale economics/finance professor, 2013 Economics Nobel Prize winner and the author of the book *Irrational Exuberance* in the 1990s), conducted by Goldman Sach’s Allison Nathan, was instructive toward understanding where psychology currently lies in US equity markets. Here are some interesting portions of the interview:

> ***Allison Nathan:*** *Is the equity market a bubble today?*
>
> **Robert Shiller:** I define a bubble as a social epidemic that involves extravagant expectations for the future. Today, there is certainly a social and psychological phenomenon of people observing past price increases and thinking that they might keep going. So there is a bubble element to what we see. But I’m not sure that the current situation is a classic bubble because **I’m not certain that most people have extravagant expectations. In fact, the current environment may be driven more by fear than the sense of a new era. I detect … anxiety and insecurity now that is a factor in markets, which is quite different from other market booms historically. [Emphasis ours – KS]**
>
> ***Allison Nathan:*** *What explains this phenomenon of asset valuations looking high across the board?*
>
> **Robert Shiller:** There are multiple answers to that question. But if I had to oversimplify with just one idea, it would be what I just alluded to a moment ago – that people are not confident in their future. They remember the financial crisis, [hear constantly about income inequality and the rise of information technology in our lives], and they worry. As a result of all this anxiety, they want to save more. But given the lack of options to invest at a high return, they end up just bidding up the prices of existing assets. **That, in turn, creates disappointment,**

more concern, and perhaps the feeling that they might be too late because of how much the market has already risen. But they still invest in it because of their anxieties.

Allison Nathan: *What does this mean for market stability?*

Robert Shiller: It means that the market could keep going up like this for some time. It's been an amazing run and looks like something that can't keep going indefinitely, but it might continue for several more years. So market bulls may be right that the market runs further. I think that could happen too. **But I take a different view of the drivers of these runs; I tend to view them as more irrational.** I just don't know when this bull market will end. **And it might end very badly.**

We want to comment on the Chinese market, of which we have bought a toehold position in some accounts. The Chinese, while introducing monstrous amounts of debt into their economy over the past 6+ years to support continued economic growth, are also trying to liberalize their monetary and financial systems in order to participate further in world financial institutions (the IMF, for example) and have stocks (and eventually bonds) included in world indices (most specifically, Morgan Stanley's industry-standard MSCI indices). In addition, they have the highest interest rates and regulatory capital requirements for their banks among the world's largest economies. Thus, we believe that their attempt to liberalize financial systems while trying to transition from an export-dominated economy to a more balanced consumer demand and export economy will proceed, but obviously not without mishaps, like the June-July drop in stock indices after the very rapid appreciation of the Shanghai and Shenzhen indices. Premier Xi's crackdown on the graft that has been inherent in the system is one way to start to change the status quo and a strong stock market will help China economically. Thus, we believe the government and the central bank, the People's Bank of China, will support the market in every way possible, allowing foreign investors to make money in Chinese markets.

Precious Metals

Precious metals have been unable to continue their 2015 rallies due to: 1) investor preoccupation with the Fed's flirtation with rising rates (which are considered poor for gold's prospects, even though the historical record shows this is incorrect), 2) lack of measured inflation, allowing investors to skip inflation protection positions in their portfolios, and 3) stigma of investing in an asset so "out of favor" for going on four years. There are concrete signs that these elements will be changing to be positives for gold and silver going forward. The following is what we see transpiring.

According to Fred Hickey in his July 5, 2015 "The Return of Stagflation," the Fed hiking rates are generally supportive of higher gold prices because most times, the Fed is considered "behind the curve" in raising rates, needing to raise rates to quell already building inflationary pressures [inflation is a real threat because rates are too low]. The current Federal Open Market Committee, headed by Chair Yellen, has already said in the past that the FOMC would likely wait to raise rates until inflationary pressures were well-entrenched in order to make sure deflationary concerns don't resurface. We also believe that inflationary pressures are already building and perceived future inflation is present in consumers' minds (chronicled below), so the Fed is already behind the curve. Thus, we think this will start to drive gold higher, just like in the past. According to Hickey:

> "The last Fed rate hike campaign began in June 2004 as the Fed raised its fed funds and discount rates in 17 "baby-steps" 0.25% increments over a two-year period. Gold soared 55% from $395 an ounce on June 30, 2004 (the day of the first hike) to $612 by the end of June 2006 (the last Fed hike). In the great 1970s gold bull market, the Fed raised its discount rate from 4.75% in February 1971 (beginning of the gold bull market) all the way up to 13% by early 1980 (the top of the [gold] bull market)…With the Fed at 0% for [almost] seven years, some central banks below 0% [Switzerland and Sweden], the Fed's balance sheet bloated, money printing (QE) all the rage and building wage and inflation pressures in the US...the Fed has NEVER been more "behind the curve" – which is wildly bullish for gold."

The lack of measured inflation is on purpose. The government benefits from having lower measured inflation through lower social security and pension payments (indexed to inflation, so lower measured inflation equals lower payments). It is also politically expedient to claim inflation is lower than actual price rises because it is easy to obscure, doesn't anger citizens and is not easily blamed on any certain official. Finally, low inflation allows the Fed more freedom in monetary policy decisions (of which easier money policies, allowed by low inflation, are much more popular with the public and especially politicians). Consumer Price Inflation (CPI) as measured by the Bureau of Labor Statistics and reported in mid-June was 0.0% year-over-year (although core CPI, which excludes volatile food and energy were up 1.7% year-over-year). However, when looking at the elements, some things seem inaccurate: although energy prices were reported down 16.3%, shelter (a euphemism for housing) was only up 2.9% during the year, medical services were only 2.5% higher and food was only 1.6% higher. These all seem very understated, considering the Case-Shiller 20-City home sales index was up 4.9% during the same period and school tuitions aren't even broken out as a category (although they represent a large <u>and rising</u> expense for many Americans). As more and more people start to feel the effects of real inflation, they will start to act more to protect themselves (buy inflationary protection assets like gold) and the statistics will gradually show more and more inflation.

Gold investing over the last four years has favored sellers, and short sellers (selling borrowed gold or gold derivatives to pay back later with hopefully lower priced gold or derivatives) have taken advantage of the weakness, shorting larger amounts and putting downward pressure on prices. Hedge funds and commodity funds that bet on direction of prices based on recent past prices have recently built the largest gold short position since statistics have been kept (this information is reported weekly by the US Commodity Futures Trading Commission), including the first outright short net position by these funds since records started being kept in 1996, meaning that the usual sellers have already sold more than their historical high sales amounts, without a large effect on the gold price. Finally, the Commercials in the gold market, generally the middlemen like large banks and metals trading shops, have their <u>smallest short position</u> of the last few years (these are usually quite short as they hedge physical positions with short futures positions – and they are generally considered the "smartest money" in the gold market. We think that this large short position is tenuous and vulnerable to a large move upward in price since there are few sellers left and buyers have seen the $1,150/oz level as very good support over the past few months. When the price turns, those shorts will have to buy to cover their money-losing positions, making gold and silver very promising for a rise in the next couple of months.

Late July update: A large "bear raid" of selling during early Chinese trading hours on Monday, July 20th finally pushed gold below its recent lows, sending mining stocks reeling during US market hours. The price break has produced financial writers of all stripes to pronounce the "death of gold." However, while this price break is a concern, we also believe that most factors now point toward the end of the bear market in gold. Factors include: 1) it has been very difficult for hedge funds to make money in financial markets recently – we believe their recent large short position in gold is "late to the party" (they are trying any strategy to make money – short gold has worked on-and-off for 4 years) and their positions are vulnerable to short-covering on any rally, 2) pessimism is near all-time lows and mining stocks are severely oversold, selling at multi-decade lows in valuation, 3) the gold price is now under the cost of production of a number of gold mines, meaning that they will almost certainly either shut down or be temporarily halted, improving the supply situation, and 4) gold in ETFs is at its lowest level since before the financial crisis, meaning a large number of gold bulls have been scared out of their positions. While we have seen similar set-ups in the past few years, none have been as severe as this episode of high pessimism, falling supply and continued monetary creation in Europe and Asia.

Energy

As we were preparing this letter, the US, Iran and some European countries agreed to a loose understanding linking the lifting of Iranian economic sanctions (including limits on oil exportation) with inspection and slowing of Iran's nuclear program. On the day of the announcement, the much-anticipated agreement caused oil to <u>go up</u>, which in our mind indicated some short covering of positions, but otherwise a general yawn for an event that was supposed to severely affect world oil markets. Market participants seem to believe more oil is not showing up imminently, and it will be awhile until it does.

Having said all that, we still believe that, even without increased Iranian supplies, the world is well-supplied with crude oil, and lower prices will force marginal producers to continue to produce at maximum capacity, keeping cash flows as high as possible but hurting the supply/demand relationship and thus future prices. No one seems immune to this pressure, as Saudi Arabia reported 7/13/15 that it is pumping over 10.5 million bbls/day (a new record) which pushes OPEC production up to approximately 31.3 million bbls/day. US production is still within a couple of percent of its multi-decade high reported in June. Also, Russia and African countries are considered in dire need of cash flow, thus they are expected to continue to produce as much as possible. With demand not expected to increase significantly in 2015, we believe that the recent swoon in crude oil prices from above $60/bbl to closer to $50/bbl is here to stay and could easily go lower as summer demand ends in early September.

Bonds

We have been surprised by the rise in bond yields last quarter, since the US dollar has stayed strong (although not bettered its mid-March high above 100.7). Longer-term US Treasury bonds seem to have been reacting much more directly to happenings and monetary sturm-and-drang in Europe since the 10-year US Treasury has virtually maintained a 1.50% yield premium to the 10-year German Bund during the Greek and European economic sagas of the past couple of months. We believe from discussions/articles from bond traders that US long rates have stayed high due to the perception that the Fed will not be raising rates in September, thus allowing inflationary pressures to build further and not raising recessionary pressures through higher short-term rates. We agree that the Fed will be extremely slow to move, but we also believe that further economic (and political, in the case of Greece and Europe) unrest will cause money at the margin to move to the US. This money will be "scared money" which will seek the safest place with a yield. That money will move into longer-term US Treasury bonds, especially if there are any bigger hiccups in stock markets in either Europe or the US.

Other Markets

The recent events surrounding Greece and its continued inclusion in the Eurozone and the euro monetary system will put continued pressure on the euro/US dollar exchange rate, as debts are not dismissed (merely postponed) and the poor competitiveness of Greece (as well as other European countries like Portugal, Italy and even France) continue economic hardship and cause European debt yields to resume their upward trajectory. We see the euro making its way below 100 to the US dollar, possibly on its way to 80 to the dollar as the US becomes the "even safer" haven, and southern European countries' economies fall into recession, in spite of the ECB's QE program.

Japan's stalling economy, coupled with its still relatively strong stock market, point to even more quantitative easing by the Bank of Japan, aided and abetted by the Abe government; thus, we see the yen/US dollar rate moving from its current 122-123/$ range past the 130/$ level in the fall, on its way to 150-200/$ in 2016-2017.

We will remain short these currencies and will probably maintain long stock markets (with currencies hedged out) in these countries, monitoring conditions for the approach of actual recessions.

KANOS
CAPITAL MANAGEMENT, LLC

Kanos Quarterly Commentary

Things Are Out of Whack! Or
The NEAR Euthanasia of the Value Investor

In Chapter 24 of his book, The General Theory of Employment, Interest and Money, economist John Maynard Keynes advocated what he called "the euthanasia of the rentier." This is a fancy phrase for getting rid of investors who live off of the interest of their debt investments, who Keynes thought were parasites living off and blocking change in capitalist economies. We are twisting this phrase because we think Keynesian thinking, concepts based on Keynes' economic work, have ruled the policies of the Fed and other central banks for too long. We strongly feel that "Keynesian economic medicine" (starving savers of interest while allowing large banks to borrow at no cost) has been applied in such large doses that it has retarded classical economic signals and led to misallocation of capital that will end in a very bad recession and poor market conditions. In addition, we believe this massive financial experiment with quantitative easing around the world has led to some unexpected conditions in financial markets that were not supposed to occur, but have not only done so, but lasted far longer than anyone could imagine

Long-time readers know that we at Kanos are market historians and tend to evaluate markets initially by comparing them to past episodes and trying to figure out how current circumstances and past market movements can help us set up or adjust portfolios for the long-term. With those thoughts in mind, there are so many conditions in financial markets that in the past have signaled eventual market movements that many participants in today's financial markets think will not happen this time around, at least not anytime soon. We thought we would examine some of these and try to see how each situation stacks up historically and what might result from each.

Massive Central Bank Interventions

As most involved in financial markets know by now, since the Fed kicked off quantitative easing in early 2009, central banks have affected financial markets in greater and greater amounts. The Bank of Japan has been aggressive in its monetary easing since the mid-1990s, but the Fed led the rest of the world into the more recent experiment in monetary easing as a result of the financial crisis starting in 2007/2008. The Fed embarked on quantitative easing (creating excess bank reserves used to then buy bonds from US banks and US branches of foreign banks) to effectively lower interest rates past 0% (where they had pegged short-term rates in December 2008). This also lowered the US dollar against worldwide currencies, making exports more competitive in world markets. As we know by now, the US financial markets recovered and rose strongly, while the US economy recovered, albeit much less strongly and is still recovering in the weakest post-WWII recovery on record. This saving of the financial system has been hailed by leaders and central bankers worldwide and now has been copied to the point of near-absurdity; according to Bank of America's Michael Harnett in a research note dated June 16, 2015:

- Central banks now own over $22 trillion of financial assets, a figure that exceeds the annual GDP of US & Japan;
- Central banks have cut interest rates 577 times since Lehman, a rate cut once every three 3 trading days;
- Central bank financial repression created $6 trillion of negatively-yielding global government bonds earlier this year;
- 45% of all government bonds in the world currently yield <1% (that's $17.4 trillion of bond issues outstanding);
- US corporate high grade bond issuance as a % of GDP has doubled to almost 30% since the introduction of ZIRP [zero interest rate policy];
- US small cap 5-year rolling returns hit 30-year highs (28%) in recent quarters;
- The US equity bull market is now in the 3rd longest ever;
- 83% of global equity markets are currently supported by zero rate policies.

Now comes the hard part – trying to exit this easy money policy. The Fed's only previous experience with extreme monetary policy was during the Great Depression of the 1930s. When the Fed tried to exit its easy money policy in 1937, the consequences were disastrous. In a March 11 note to investors, Ray Dalio's Bridgewater Associates warned of the dangers of raising rates, even a little, in a post-recessionary still-fragile economy and financial markets:

> "*The first tightening in August 1936 did not hurt stock prices or the economy, as is typical. … The tightening of monetary policy was intensified by currency devaluations by France and Switzerland, which chose not to move in lock-step with the US tightening. The demand for dollars increased. … The economy remained strong going into early 1937. The stock market was still rising, industrial production remained strong, and inflation had ticked up to around 5%. The second tightening came in March of 1937 and the third one came in May. While neither the Fed nor the Treasury anticipated that the increase in required reserves combined with the sterilization program would push rates higher, the tighter money and reduced liquidity led to a sell-off in bonds, a rise in the short rate, and a sell-off in stocks. Following the second increase in reserves in March 1937, both the short-term rate and the bond yield spiked. … Stocks also fell that month nearly 10%. They bottomed a year later, in March of 1938, declining more than 50%.*

Or, as Bank of America's Michael Harnett in his 6/16/2015 research report summarizes it:

> "The Fed exit strategy completely failed as the money supply immediately contracted; Fed tightening in H1'37 was followed in H2'37 by a severe recession and a 49% collapse in the Dow Jones."

Our concern is this: the Fed, now followed by virtually all the central banks of the world, especially the large ones, have embarked on a largely untried policy of ultra-low interest rates brought on by massive, massive liquidity injections. It has been nine years since the Fed last raised rates (in 2006), and by one count, at least one-third of all employees in the financial firms facilitating world financial markets have never participated in an interest-rate tightening cycle. Possibly most importantly, central bank movements are almost universally inertial, meaning that they continue in one direction for a long time before reversing and moving in the opposite direction. The Fed has been easing since 2008 – when they start tightening monetary policy and raising interest rates, financial firms will have to switch their models to show higher interest rates in the future, driving up financing cost projections and raising discount rates for evaluating investments, which should make investments less attractive and drive down their prices.

Thus, we are concerned that investors and consumers have gotten used to low and falling interest rates. So when interest rates start to rise, they could change their behavior, using more caution in buying due to higher financing costs. Investors could act the same way, shunning high priced investments due to higher financing costs and lower expected returns. The Fed has a very difficult job ahead of it, but it caused the problems by implementing extreme doses of monetary policy and leaving them in place for years past the time of the financial emergency of 2007-2009.

Extremely Low Bond Yields

The Great Financial Crisis led to very large amounts of financial assets becoming worthless or worth far less than their quoted prices just months before "the storm" hit. As risky assets were imploding, investors poured into safer investments, with US Treasuries being the most popular. In fact, we remember T-bills (extremely short term Treasury Bills) trading at negative rates, showing extreme risk-aversion as people were willing to lose money to make sure the majority of their money was ultra-safe. As the panic spread, asset prices plunged and people took off leverage. Fears of deflation and depression drove down 10-year US Treasury bond rates from above 4.00% during the summer of 2008 to a low of 2.08% at panic lows in November 2008. As panic subsided and the stock market bottomed (due to huge amounts of governmental and Fed stimulus support), T-bonds recovered and traded as high as 3.98% in mid-2009. The Fed instituted QE2 in 2010, which required buying large amounts of T-bonds and drove yields down to 2.41% before they again snapped back higher. The Fed still thought the economy was too weak in 2011, leading to Operation Twist/QE3 (fully instituted in 2012), which drove interest rates below the 2008 panic bottom for more than two years, bottoming in April 2012 at 1.43%. Since that bottom, T-bond rates bounced up to 3.04% at the end of 2013, fell to 1.68% in January 2015, and currently hover around 2.30%.

The reason to highlight these events is to show that although the US economy has recovered from its 2008/2009 economic lows, interest rates have not been allowed to rise to free market levels. The Fed and foreign central banks have held interest rates down – not just short rates (like the overnight rate) held at 0% for 6 ½ years and counting – but long-term rates. Fed buying and financial institution buying (regulatory requirements for banks favor holding Treasury bonds due to low reserve requirements for them) have driven down long-term Treasury rates, which have kept corporate bond rates (priced off of similar duration Treasuries) historically low.

Foreign central banks have obviously been influenced by Fed tactics and results, with Japan, Europe (including non-EU European central banks like Sweden) and China engaging in large quantitative easing programs, pulling down interest rates (in some cases to 700-year or truly all-time lows); here are the current 10-year yields from around the world (as of July 10):

United States:	2.39%
Canada	1.68%
Germany	0.89%
UK	2.08%
France	1.28%
Italy	2.13%
Spain	2.12%
Switzerland	0.06%
Japan	0.44%
Hong Kong	1.80%
Australia	2.93%
India	7.80%

We are concerned that in the future these rates may not react to central bank and governmental efforts to keep them low in the future; the German bund move from 0.05% to 0.95% mentioned above is an example of this. Stock markets may also react in unanticipated ways. The Chinese Shanghai and Shenzhen markets rose strongly during the first six months of 2015, only to suffer a crash in late June/early July due to margin calls and undercapitalized players. China's reaction of lowering interest rates, extending more credit (including directly for stock market margin loans) and supporting banks did not stem the decline, which ended up being 32% from the highs over a little more than two weeks. While people in US and European markets assure themselves that "it could never happen here" because of our financial sophistication and supposedly relatively strong economy, high valuations in developed markets, along with high levels of margin debt and high momentum in many faddish stocks in the social media, biotech and consumer discretionary sectors could lead to a lot more turmoil than many believe is possible.

Negative Bond Yields in Europe

Negative short term (and in some cases, medium term) rates occurred earlier this year in a number of European countries, although rates have risen in many of the countries so that negative rates are not as widespread as they were in March. The fact that negative rates occurred at all is very surprising. While there have been occasional uses of negative interest rates to discourage savers from using Swiss banks, there have never been negative interest rates used to encourage investment (that we can find). In other words, even during the depths of the Great Depression in the 1930s, severe panics in the face of two world wars, etc., we don't believe governments/central banks have ever had to resort to "paying people to take money," which is essentially what negative rates mean. This goes to show the extremes of low interest rates morphing from the distortive effects of quantitative easing (meant to lower effective interest rates when rates are at or near 0%). We believe that the continued existence of negative rates (short- to medium-term Swiss bonds trade for a negative interest rate, as do many short term European bonds) means there are serious problems in the Eurozone that will soon lead to recessions in many countries and some bankruptcies of large companies or pension funds or municipalities – the kind of thing that is driving investors to keep paying someone to keep their money safe. "Safe from what?" – that is what we continue to ask.

No Measured Inflation

We covered this topic in the "Going Forward – Precious Metals" section above, but in a nutshell, with high asset prices, rising food, fuel, housing, tuition and, in some cases wage costs, we expect inflation to show itself to be far higher than the flawed measures of inflation have shown in the recent past. We believe that we have been going through a mild form of stagflation, meaning anemic economic growth but with inflation. We expect more monetary easing to occur in the future as economic growth stalls out further. This will cause more inflation and lead to higher measured inflation and far higher inflation expectations in the future. People expect higher prices for many things they buy, but surveys say they don't have inflationary expectations. This seems like an anomaly that will die out in the next few months.

Commodities Price Crash

Commodity prices rose throughout the first half of 2008 even after most world stock markets had peaked in late 2007 (including China's market). When commodity prices crashed starting in July 2008, world stock markets followed, and we all know what happened – most markets lost between 35-45% (from peak to trough) in relatively short order. We believe that stock markets were signaling a topping in demand, and as the supply/demand statistics started to appear in the commodity markets, they adjusted down very quickly, expressing this supply glut caused by a demand shortfall. Another example occurred in the 1920-21 depression, chronicled in James Grant's new book, The Forgotten Depression (1921: The Crash That Cured Itself), he writes: "The depression rather made its presence felt with the serial crashes of dozens of commodity markets. To the affected producers and consumers, the declines were immediate and newsworthy, but they failed to seize the national attention. Certainly, they made no deep impression at the Federal Reserve."

Now let's fast forward to 2011-2015. Since their post-financial crisis recovery high in May 2011, commodities, as represented by the Reuters/Jefferies CRB Index have fallen 38.4%, with crude oil falling just over 50% in just the last 8 months, copper falling 44% since 2011, base metals (aluminum, zinc and copper – as represented by the base metals ETF DBB) down 43% since 2011, and even cotton, down a whopping 71% since 2011. As the 2007-2009 and the 1921-1922 episodes above illustrate, crashes in commodity markets strongly indicate a supply/demand mismatch that is usually an instantaneous indicator of falling demand (obviously in relation to available supply). It represents a worldwide supply/demand imbalance, and Asia, led by China, has a big influence on this balance. However, the US is the largest economy in the world and has a large effect also. The fact that many in financial markets believe the US economy is gaining strength (due to late cyclical indicators like employment, which typically peaks after economic growth has peaked and is weakening) in the face of such huge falls in commodity prices is incredible to us. But as stated above, large scale financial intervention by central banks tends to postpone results, so it appears that the US "recovery" will continue to bump along until the financial stimulus effects run out.

Divergent Movements in Major Stock Indices

Just like the extreme underperformance of commodities referenced above could be a harbinger of future economic weakness (and possibly lead to financial weakness), the divergence of some major indices in the US stock market worry some stock market veterans. First, one of the oldest (and supposedly most successful) technical market indicators is The Dow Theory, where the Dow Jones Industrials move in the same direction as the Dow Jones Transports ("industrials makes the goods and transports haul them"). Since late 2014, the Dow Jones Transports have been far weaker than the Industrials, hitting their all-time high in late November 2014 and dropping since then, currently down more than 10% from those highs. However, the Dow Jones Industrial Average has continued to hit new highs in 2015, reaching its all-time high in late May 2015. The Transports should be strong due to far lower oil prices (their main input cost besides wages) than in the past four years; however, after last fall's rise, they have been constantly weakening. This divergence concerns a number of market veterans, because the longer these indices diverged in past episodes, the more certain was the probability that they would re-connect, but this time to the downside. So unless the Transports can recover to set a new high above last November's, Dow Theory says the Dow Jones Industrials (which represent the biggest and strongest companies of the US stock market) are vulnerable to a potentially significant downside move.

In addition, the Utilities, which are very interest rate-sensitive, rose sharply throughout last fall and January 2015, but have fallen from those highs since. Utilities are usually considered an indicator that foretells weakness in the US stock markets. Most famously, the Dow Jones Utility Average topped out a few months before the stock market hit its highs in 1987, just weeks before the Industrials fell more than 22% in a day during the Black Monday Crash of 1987. Some analysts had warned that the topping of the Utilities and their subsequent weakness, while the DJ Industrial Average continued to rise, meant the Industrial Average would drop soon after. Currently, there are analysts who are concerned with the weakness in the Utilities and longer-term bond yields (which are down for the year) and believe that the weakness in bonds could soon migrate to stock markets. In mutual fund flows, bond funds have seen strong outflows this spring/early summer, as have Utility funds, while stock funds have received some of this capital, showing public moving from weaker bonds/utilities to equities, which are facing strong dollar earnings headwinds and high valuation concerns. We are concerned about both of these indicators, believing that divergences typically signal warning signals, and this is another reason we are wary of too much momentum stock exposure.

Strong US Dollar with Weakening US Treasury Prices

A related divergence is the weakness of US Treasury bond prices (higher rates) in spite of a strong US dollar. While the ebb-and-flow of currency movements contain a lot of useless "noise," we believe that bond prices should have been rising in 2015 with the continued strength of the dollar. However, it hasn't happened – why? We believe the best explanation is that the dollar continues to act as a safe haven, but people are wary of the Fed NOT raising rates anytime soon, which they believe will cause more inflation, meaning those dollar investments are going into short-term instead of long-term bonds, making the yield curve “steepen”. A steepening yield curve is usually a harbinger of inflation. But this brings back the question – if the bond market is signaling increased inflation, how come commodities and precious metals aren’t signaling the same?

Rise in Stock Markets with Either Slowing or Near-recessionary Economies

This, of course, is the question that we get asked a lot – if Japan or Europe are in near-recessionary conditions, how can we invest in them? We believe that the psychology and monetary muscle of central bank easing tends to push up stock markets for as long as reserves are being put into each country’s banking system. Thus, in spite of slow economic growth in Europe and Japan, their quantitative easing programs continue to drive markets higher. However, with the US QE program finished, and economic growth uneven (even after a negative GDP print in the first quarter), we think a slow economy threatens the future of a highly valued, long-in-the-tooth US bull market. Thus, we have continued to limit our US investments to strong, under-valued companies in attractive sectors.

As value investors, we look at historical valuations, typical relationships of economic forces and interactions in financial markets, and economic and financial market signaling to help us make good investment decisions. As these “inconsistencies” resolve themselves, we believe we will be able to use all of our historical “tools” to better direct your investments for strong, value-driven returns. Manias don’t last forever, and this one is getting very old.

The Managers of Kanos Capital Management