KANOS
CAPITAL MANAGEMENT, LLC

Third Quarter 2015 Investor Letter

Portfolio Comments

Ding, dong, the myth is dead (or is at least dying). The myth of US Federal Reserve ("the Fed") omniscience and the beginning of the end of central bank economic planning occurred in steps during August and September, leading to upsets in the financial markets throughout the quarter. The Fed's insistence on telegraphing a rate hike led to a soaring US dollar in July, crushing our energy, Asian stock and metals investments. However, as the Fed finally saw slowing US and international growth, they started back-tracking step-by-step on their interest rate vow, which roiled worldwide stock markets, but stabilized gold and oil, leading to our portfolios outperforming in August when the US stock market performed the worst. Our currency positions, which had done so well for most of the year due to a rising US dollar, gave back some gains and stayed relatively flat for September. The failure of the Fed to raise rates at the September meeting led to higher prices for our bonds, precious metals and overseas stocks by mid-September, but most of our positions, and most other US stocks, sold off into the close of the quarter, with investors expecting the Fed to raise rates in October, or at least at their December meeting. **Spoiler alert:** when the jobs report for September was released on October 2nd and showed far weaker job creation for July, August and September than expected, investors finally no longer feared the Fed and a rally in both stocks and bonds has ensued since then, led by precious metals miners and commodity stocks, up ~15+% for October through 10/27/2015.

In late October, we still find it hard to determine whether recent stock market activity is in the last stages of the bull market off the 2011 lows (the last time there was a 10% correction) or a bear market rally (off the May 2015 highs and won't reach them again.) We tend to believe that the bull market could continue through the end of 2015, but we also think that the May/July highs seen in various indices may be the ultimate highs. In addition, we believe the US dollar will remain strong and the Fed will not increase interest rates any time soon, probably not until 2017, after the presidential election.

In spite of the possibility of stock market weakness, our portfolios are well-positioned to take advantage of the current rally and future run-ups while remaining relatively defensive compared to the broad market through de-emphasizing high-valuation growth stocks vulnerable to drops due to earnings disappointments and/or revaluation. We maintain a large amount of equity exposure, primarily in large domestic companies with sustainable businesses, reasonable valuations and dividends and in select foreign stocks (Asian and multinationals) with attractive fundamentals, while keeping a larger amount of cash than normal to either increase exposure if we continue higher or have a cash cushion for future purchases if we head lower. Additionally, we hold investments, such as long-term Treasury bond ETFs and precious metals and

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mining stocks, that provide income, stability and a safe haven from a slowing economy and/or central bank policy instability, and we own currency positions that also reflect central bank policy stances that continue to be long-lived. Fortunately, we have not bought into the idea of Fed omnipotence over an extremely complex US economy and financial markets, so we were not significantly impacted by the extreme correction in August. We were positioned with fewer high-valuation growth stocks and instead had higher allocations to better performing assets.

We further project that over the next few years, the S&P will return a low yield (~1.5% annually) and that our portfolio concentrating in companies that have not performed as well lately will far outperform the S&P. Owning non-S&P stocks or underperforming S&P stocks in the US, plus international stocks, bonds and currencies, will allow us to far outperform the indices in the future.

Third Quarter Market Conditions

July was characterized by a stronger US dollar, losses in emerging markets (especially Chinese stocks) and a rout in commodities. The losses were the worst in the oil complex: West Texas Intermediate (WTI) oil lost 21% during the month, Brent oil gave up 18% and oil equities lost 7.65% (as represented by the S&P Energy index). Emerging markets had a bad month: the Shanghai composite lost 13%, the MSCI Emerging Markets stock index lost over 5%, and Brazil’s Bovespa lost 5%. Other commodities also suffered: Wheat was down 20% during July, corn dropped 10% and copper dropped almost 9%. Winners during the month were European stocks, with Italian, Spanish, Portuguese and German stocks gaining between 3-5% for the month. The S&P 500 was up 2.1% during the month, led higher by a shrinking number of large-capitalization stocks. The Utilities, Consumer Staples and Consumer Discretionary sectors were up the most while the Energy, Materials and Telecom sectors were down. Bonds were mostly flat for the month; Treasuries, corporates and high yield bonds were mostly fractional gainers. Gold and silver lost 4-5% during the month as they were lumped in with commodities. The precious metals miners performed even worse, setting new multi-year lows.

August, as we all know, brought some extreme equity volatility, punctuated by the 1,089 point drop in the Dow Jones Industrial Average at the open on August 24th. While equity markets did recover some of their drop, it was a bad month for stocks, with the S&P 500 dropping 6.26% (only 6.03% after dividends). All sectors of the S&P were down for the month, with Utilities and Telecom down the least, while Healthcare, Financials and Consumer Discretionary suffered the most. Bonds were also volatile, falling early as investors expected economic growth and rate hikes, rising strongly during the equity markets’ volatility, then falling late in the month as stock markets settled down, resulting in bonds closing near unchanged. Gold was the star of the month, up 3.4% (along with gold mining companies up 2.6% as represented by the Market Vectors Gold Miners ETF), although silver was down 0.8%. The most “action” during the month was the extreme volatility in oil prices, which dropped sharply throughout most of the month (this extreme weakness was part of the cause of equity weakness), but then WTI rallied **27.5%** in the final three days to close almost 5% higher for the month. The US dollar was down for the month as US markets were the epicenter of financial market weakness, and unwinding carry trades led investors to push up the yen and euro 2.1% versus the dollar

as they paid back borrowings in those currencies. International indices were generally weaker as decelerating Chinese growth and its side effects affected many major indices: China as down 15%, Germany's DAX was down 12% and Japan's Nikkei was down 10%. Most other major European indices were down between 5-10%. Finally, a number of investment funds showed extremely weak results in August: Leon Cooperman's Omega Advisors was down 12% for the month while Dan Loeb's Third Point (-5.3%) and William Ackman's Pershing Square (-4.3% YTD) wiped out the year's gains with poor August results (-13.1%) [through August 25th according to media reports in the NY Times, WS Journal and Yahoo Finance].

September was a difficult month for virtually all asset classes, with only "beat up" markets like US grains and Greece gaining more than 2%. The "event of the month" for September was the Fed's decision on 9/17 to not raise rates (taking many people in the markets by surprise, since they felt the Fed had "signaled" higher rates); this decision led US stocks (and many world stock markets and commodities) to give up all their intra-month gains and show losses – as "higher interest-rate plays" (like financials) were sold. The winners for the month were bonds, as Treasuries, German Bunds, other developed European sovereign bonds and US investment grade bonds gained between 1-2%. The S&P 500 index was down 2.47% (after dividends), with Utilities and Consumer Staples the only sectors rising during September. The losers for the month were the Materials, Energy and Healthcare sectors. Industrial commodity stocks moved to new lows during the stock market turmoil, while the overheated Biotechnology stocks led the Healthcare sector lower. WTI crude and Brent were the big losers for the month, down 7% and 9%, respectively, but this was after a large late-month run-up in August [as mentioned above]; oil prices have been consolidating for much of the month and look to break either higher or lower later in the fall. World stock markets, including developed European and Asian markets, all finished with losses of approximately 3-5% for September, with the Nikkei showing the biggest drop (6%). Precious metals gave back some of their August gains, with gold dropping approximately 2% and silver 1%, although the mining stocks underperformed the metals but outperformed most commodity stocks.

Equities

Equities, plagued by what more and more people consider a split and confused Fed, underperformed as growth expectations were re-evaluated and slowing economies worldwide led to lower sales, exacerbated by a strong US dollar. The S&P 500 index ended the quarter down 6.44% (after dividends) and is down 5.29% year-to-date. Only the Utility sector was up during the quarter, gaining 2.92% (net) but is down 5.85% YTD (net of dividends). All other sectors were down during the quarter, with the underperformers led by Energy (down 17.41% (3Q) and 21.28% (YTD), net of dividends), Materials (mostly chemicals, steel and aluminum – down 16.9% (3Q) and 16.48% (YTD), net) and Healthcare (led down by the formerly high-flying biotechs – down 10.67% (3Q) and 2.13% (YTD), net). The Financials gave back all their early year gains during the August decline, and finished at new yearly lows in September after the Fed declined to raise rates, dashing hopes for higher margins for the banks. Major world stock markets were all lower for the quarter: China's Shanghai composite was the worst performer (-24.6%), followed by Hong Kong (-17.7%), Brazil's Bovespa (-15.7% [but down 34.2% in US dollar terms, showing how much the Brazilian Real dropped

versus the US dollar]), Japan's Nikkei (-13.4%), Germany's DAX (-10.1%) and the UK's FTSE 100 (-6.9%).

We believe a number of factors caused these losses:

1) Growth expectations worldwide (especially in China and other emerging markets) were judged to be weaker than previously thought, leading to a sell-off in equities around the world;

2) A split in Fed opinions appeared, making the Fed look in disarray; we believe the large August decline and the late-September slide were both caused by changing investor opinions about the Fed. The August slide started after the Fed minutes from July's meeting showed caution about the US economy due to worldwide economic uncertainty [the Fed has rarely mentioned international developments and was not thought to include them in their decisions]. The September meeting not only did not raise rates (after so many FOMC participants had hinted about a rate rise), but concerns about worldwide market stability appeared to be treated as a "third mandate" for the Fed to consider, confusing financial markets and making financial market participants worry about Fed missteps as they try to adjust monetary policy for the world as a whole.

3) Investors sensed weakness in aggregate world demand as expressed most poignantly by falling oil prices. The pervasive weakness of oil prices during July and most of August appeared to lead stock markets lower as stock traders watched oil prices for directional cues much more than normal. Many times, lower oil prices are judged to be good for economies, lowering inflation and leading to lower energy costs for consumers. But in 2015, lower prices are judged to be caused by dropping demand, signaling faltering economic growth around the world.

4) The Chinese mishandled the promotion of their stock markets for consumer investment with "ham-handed" attempts to support the markets through only periodic and poorly-communicated capital supports. Outlawing and prosecuting alleged short-sellers and failure to reassure markets when large losses were sustained were also major contributing factors. These uncertainties led many to not only sell all Chinese holdings but many to sell other holdings to cover losses in Chinese markets.

5) High valuations and disappointing economic statistics in the US led more people to lighten positions, especially as panic gripped the markets on the morning of August 24th.

Energy

The energy arena was a bloodbath during July and most of August, when oil prices gave back all the spring gains in price in the span of only about 55 days, falling from near $60/bbl to a new 6-year low of $37.75/bbl on August 24th. Prices recovered strongly in the last couple of days of August as many judged prices had fallen too far. Amazingly, despite the latest price declines, there appears to be more

"big money" bets that a bottom has now been reached; in a smaller-scale repeat of the March-April price rise (when WTI rose from its $42.50 bottom to a high of $62.58), prices closed August near $50/bbl after its late August low. The sideways movement of the prices during September encouraged more participation as the market seems to be split equally about the future of prices to break either higher or lower in the near future. Amid all the volatility, WTI crude ended the quarter at $45.09/bbl. Natural gas stayed in a range all quarter between $2.55/MMBtu and $2.95/MMBtu, but with low demand autumn approaching, natgas closed at $2.524/MMBtu, at the lows for the quarter.

Precious Metals

Precious metals recovered some of their July losses during August and September, but not enough to show gains for the quarter. Gold was down almost 4% for the quarter to end at $1,115.50/oz, with silver down almost 7% (closing at $14.513/oz). Both were caught in the July commodity selling frenzy when investors dumped precious metals when oil and many other industrial commodities lost 10-20% in July. Gold, and to a lesser extent silver, showed their value as stores of value during the quarter's times of turmoil, rising 3.4% during a "bloody" August for many financial assets and recovering some early September losses after the Fed decided to hold interest rates steady (amid renewed turmoil in most financial markets).

Perhaps the best illustration of gold's September performance can be seen in the chart below in the end-of-day recap article from ZeroHedge on 9/29/2015 sourced from Bloomberg; the left side of the chart is indexed to the 9/17/2015 release of the FOMC to hold rates steady. As you can see, stocks, as represented by the green line with the S&P label, dropped for most of the rest of the month, but gold initially rose and then held much of that rise throughout the end of the month (the gold line with the Gold label).

Bonds

Sovereign and investment-grade bonds outperformed all other financial assets in the third quarter. European developed bonds performed the best, gaining between 2-4% for the quarter, while longer-term US Treasuries gained approximately 2% (before interest). As shown in the chart above, 30-year Treasury bonds (as illustrated with the blue line labeled 30Y Bond Fut[ures]) performed very well during the equity weakness after the Fed held short-term rates steady, and equity markets sensed economic weakness and further uncertainty.

The benchmark 10-year Treasury bond gained in price during the third quarter to yield 2.061%, a strong gain from 2.335% yield at the end of the second quarter and from the end of 2014 closing yield of 2.175%. The Treasury bond positions we own proved their value during the two large equity declines during the quarter. In the Stockcharts.com chart below of the iShares Barclays 20+ year Treasury Bond ETF (exchange traded fund with the ticker TLT), we have marked (with blue circles) the two days of large gains in Treasury bonds – the first on August 24th when the Dow Jones Industrial Average lost almost 1,100 points on the open, and the second one on September 17th when the FOMC announced they were not raising short-term interest rates (causing stocks to lose value for the next several days and Treasury bonds to gain in value).

In contrast, we present on the next page the Stockcharts.com chart of the iShares iBoxx High Yield Corporate Bond ETF (ticker HYG) that shows high-yield or lower rated bonds (with the nickname "junk bonds" which are below investment grade) during the same period. As you can see, lower rated bonds (which many investors own due to their higher yields and relatively low current predictions of default due to continued low interest rates) performed very poorly, plunging in late August when equities were falling, then mirroring declines in equity indices during late September and closing on their lows. This correlation with stock weakness conforms to historical precedents, which is why we have avoided these types of investments. In addition, we are concerned about the illiquidity of bond trading supplying these large lower-grade credit funds. We believe we could see real distress if too much selling of the ETFs causes a dumping "at any price" of the bonds in these types of funds.

Other Markets

Major currencies were generally less volatile than in recent quarters, and most moved in relatively small ranges for the quarter. The US dollar gained a bit more than 2% versus the Japanese yen, although it was virtually flat versus the euro. However, this masks the US dollar's strength against most other currencies; the dollar was strong for virtually the whole quarter versus the Canadian dollar, the Australian dollar, the Mexican peso and the Chinese yuan. There has been a lot of commentary after the Chinese stopped pegging the yuan to the US dollar in August; many blamed this small devaluation for much of the US equity market decline in August. However, the Chinese have been losing exports to the Japanese because of the weakness of the yen for almost two years. Other countries, like South Korea, have weakened their currencies to try to maintain their exports. With European quantitative easing and the resultant drop in the value of the euro, Germany and the rest of the EU have maintained the competitiveness of their exports, further hurting Chinese competitiveness. As part of its financial reforms needed to be included in the International Monetary Fund's (IMF)

official reserve currency basket (included in the IMF's Special Drawing Rights basket), China was required to float its currency – which it started to do in August. Protectionists from around the world howled that China was "weakening" its currency to re-establish its strong export position it formerly had in the 1990s/2000s. We believe this is false due to the relatively small devaluation (2-4%) that occurred, especially when compared to the overall 70% fall in the yen and the more than 30% fall in the euro in the past couple of years, not to mention the requirement by the IMF to float the yuan.

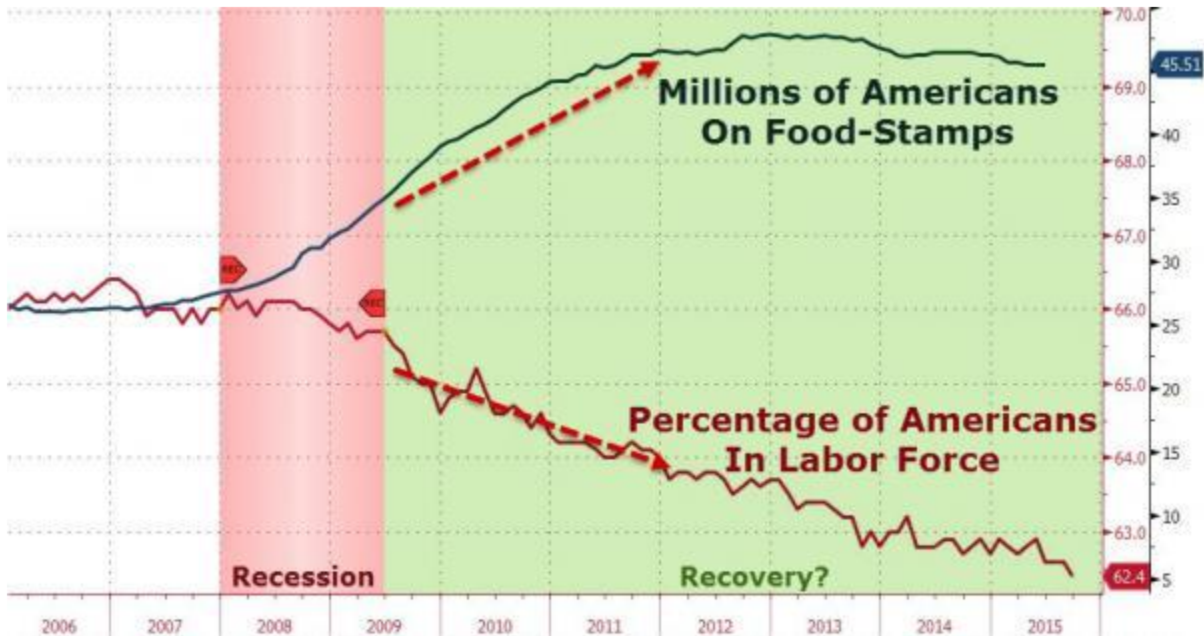
Going Forward

Economy

While the financial press doesn't pay as much attention to the Fed's regional economic surveys as they do the Institute for Supply Management (ISM) monthly surveys of regional and nationwide Manufacturing and Non-manufacturing activity, we believe these Fed reports show a more timely (and probably more accurate) report of economic activity than other government data. With that in mind, the six regional Fed surveys (New York, Philadelphia, Richmond, Dallas, Kansas City and Chicago) show a pronounced weakening of the US manufacturing economy, and the ISM surveys show distinct slowdowns, with the Chicago ISM survey showing outright contraction (a reading of 48.7 on a 0-100 scale). We believe these readings are another reason the Fed didn't raise interest rates – manufacturing in the US is weak due to a strong US dollar and slowing domestic demand, hardly an environment in which to raise rates.

Add to that the October payroll report (issued October 2nd) which was described by a number of market watchers as "horrible": 142,000 jobs were added (at or near the lowest in almost two years) versus expectations of 203,000. Revisions to both July and August reports cut jobs by another 59,000 jobs (when most had expected at least an upward August revision since it had happened the last five years). The other payroll report [the "household report"] actually showed a -236,000 print, a diminished hourly work week (work by current workers dropped on average) and average hourly wages without any increase. The amount of people not in the labor force rose another 579,000 people to reach 94.6 million, dropping the Labor Force Participation Rate down to 62.4% of the US population, a percentage not seen since 1977 (which actually is a worse number than reported because of a much larger percentage of women in the labor force today than in the 1970s). In addition, October factory output (for August) dropped 1.7%, the tenth negative reading in a row (year-over-year), with sales dropping even faster and leading to a higher inventories-to-shipments ratio. Finally, the Atlanta Fed's "GDP Now" model (which has more accurately forecast the direction and strength of US GDP readings lately) dropped to a 3Q reading of 0.9% growth, following a weak international trade report for the US. These readings are all things that occur going into or during recessions. We are very concerned about the rate of slowdown in the US economy.

Finally, we saw one more chart as we were writing the letter that brings up one more question about the sustainability of the "recovery" in the US economy. The following chart is from a ZeroHedge article on 10/5/2015 titled "The American 'Recovery" in 1 Chart":



Equities

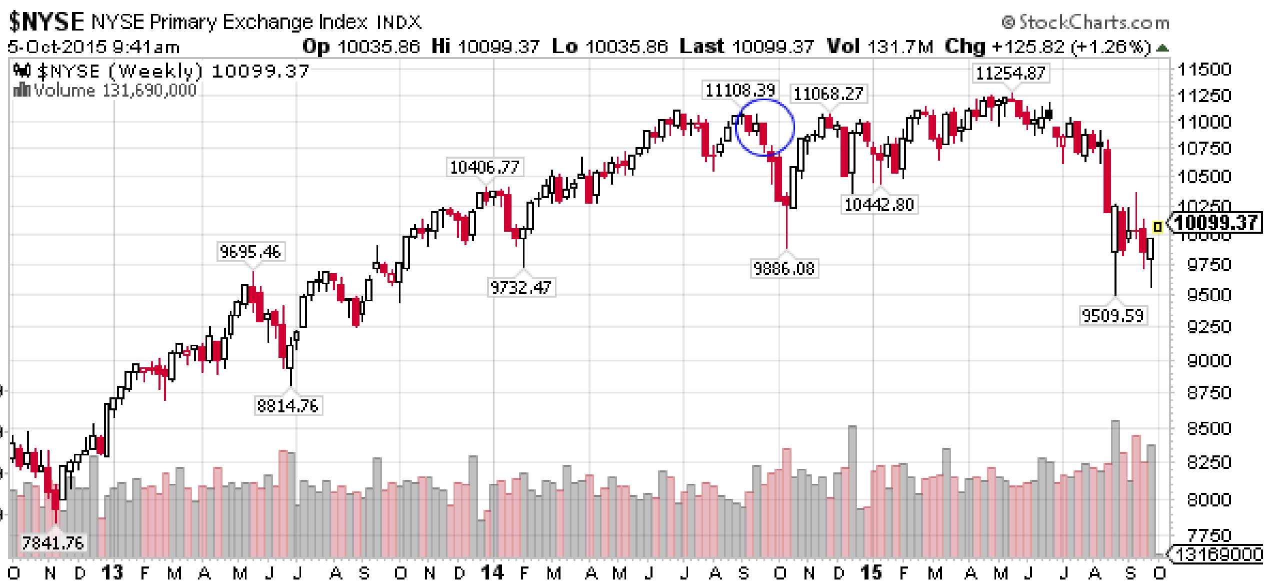
Stock markets have continued to rally in October off the end of September low. By some measures, this "snap back" rally is the strongest since the 2009 rally off the last big low, mostly because the biggest rallies have come from some of the worst performing stocks of the last two years, led by Materials and Energy companies. In contrast, many former "leaders," including biotechnology and the some technology stocks have lagged the gains of the market during October. However, merger activity and strong technology earnings by a few leaders (mostly the "mega-caps: Amazon, Google, Microsoft and Facebook, most notably) have led to higher stock prices across-the-board in late October, leading to more stock market strength although on narrower breadth.

As mentioned on page 1 in our Portfolio Comments, it is still hard to tell if recent stock market activity is in the last stages of the bull market off the 2011 lows (the last time there was a 10%+ correction) or a bear market rally (off the May 2015 highs that won't be reached again). Thus, we are maintaining a large amount of equity exposure while keeping a larger amount of cash than normal to either increase exposure if we continue higher or have a cash cushion for future purchases if we head lower.

Not surprisingly, we are concerned about US equities and emerging market equities due to: weakening fundamentals (poor expected and reported Q3 earnings of most companies), high valuations, damaged technicals in the US and high debt levels combined with faltering world demand for emerging market

exports. On the other hand, the bulls have insisted that the US economy is in a strengthening recovery and that is evidenced by a strong stock market and constant employment gains for the last few years.

While the US economic recovery in 2009-2011 was sustained (but the weakest since before World War II), the outperformance of the stock market from 2011-2014 was far stronger than the slow-growth US economy should support; it most probably is a result of relatively constant "emergency-level" monetary stimulus (quantitative easing). As we have shown in previous quarters (and is indicated in the blue circle in the chart below), once QE3 bond purchases ended in October 2014 (resulting in a violent 10% correction in the stock market and was only rescued by Kansas City Fed President Bullard's suggestion of further quantitative easing), the stock market ceased its pronounced upward trajectory, has essentially flat-lined since then, and with the Fed suggesting slower growth both domestically and internationally with their commentary and vote of no rate hike, the stock market has been volatile, bouncing on news that points toward lesser chance of Fed rate hikes, but swooning on news that might convince the Fed to tighten.



Even with a continuing October recovery in stock markets, we cannot tell if current easy monetary policy will push up the markets it has helped propel for the last few years. If stocks move to new highs, then August was just another nasty correction similar to the summer of 2011 when the market dropped approximately 24% before resuming its rise (although it was helped along by an actively accommodating Fed, which we don't appear to have presently). But with no new monetary stimulus injected into the US financial system since September 2014 and earnings looking like they are going to drop for the third quarter in a row (despite the majority of reported earnings "beating expectations" of analysts, overall earnings are expected to be down 5.1% year-over-year), we have our doubts that the rally has enough gas to propel the markets to new highs.

If we are in the early stages of a bear market, it will be something we haven't seen since 2007-2009. The following factors point us toward this weakness being serious and continuing:

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1) Much higher and sustained volatility in the market (as best indicated by the VIX Index above 24 through most of September, long after the August "rout" was over);
2) The amount of advancing versus declining stocks has been falling for months (which peaked in May 2015 around the same time the S&P 500 index peaked);
3) High yield debt has been showing weakness since peaking in early June;
4) Volume on down days in the market is greater than volume on up days;
5) Commodities have shown extreme weakness, which often presages equity market downturns;
6) Emerging market stock markets have shown continuing weakness, having peaked in March;
7) Small-cap stocks have underperformed large-caps, showing reduced risk tolerances; and
8) Margin credit in the US has peaked and fallen, often presaging stock market weakness.

While some of these conditions have moderated during the October rally, weak earnings, a strengthening US dollar and growing geopolitical and economic concerns abroad could lead to more weakness.

In spite of the possibility of stock market weakness, our portfolios are well-positioned to take advantage of the current (and any subsequent) rally while remaining relatively defensive compared to the broad market through de-emphasizing high-valuation growth stocks vulnerable to drops due to earnings disappointments and/or revaluation.

With that in mind, we:

a) Continue to own stocks of large domestic companies with sustainable businesses, reasonable valuations and dividends;
b) Own and possibly could expand our holdings of long-term Treasury bonds (in the form of ETFs) to provide income and stability in volatile financial markets and a safe haven that tends to benefit from stock market weakness and a slowing economy;
c) Own precious metals and mining stocks that provide a safe haven during market turmoil and respond to central bank policy instability (and should benefit from further central bank stimulus);
d) Own currency positions that reflect central bank policy stances that continue to be long-lived;
e) Own select foreign stocks (and/or ETFs) that have attractive macro-economic situations or attractive fundamentals in sectors;
f) Own companies with higher current yields that we believe will hold their value in uneven markets; and
g) Hold cash to be able to buy into attractive future situations.

If weakness in markets reappears, we may also buy some inverse ETFs that serve as stock index hedges against further weakness. However, we are currently hesitant to hedge much with the longstanding "buy-the-dip" mentality still intact as evidenced by the October 2nd market turnaround after the poor October employment report.

Precious Metals

Since 2012, gold has been fighting against two headwinds: the ascendency of central banks and the narrative of economic growth that eliminates the need for havens like gold and Treasury bonds.

We believe the current description of the gold market from the 10/15/2015 issue of **The Gold Stock Analyst** ("GSA") gives a very good recap:

> "Gold gained $20/oz to close Oct 14 at $1,185/oz, exactly where it began 2015 and over $100/oz above its mid-July low. For technicians, it also crossed the important 200 day moving average at $1,176. "With these two bullish signs, it's worth examining the case for gold to head higher…here's why GSA sees gold higher in the near future:
>
> 1) Seasonality: In the West (Americas and Europe), Christmas is a gift-giving time and often involves gold jewelry purchased in the preceding several months. In the East (India), the wedding seasons are November-December and late March to early May. Gold and silver jewelry is a traditional gift.
> 2) Physical market is extremely tight. On Comex [US gold futures market], the ratio of open interest to registered (deliverable) gold was 10X to 15X from 2000 through 2008. Now the ratio is over 250X, with just 171K oz of gold available versus 43 mil oz of open interest. Ounces have been sucked from the Comex by demand for the physical … Something has to give, like shorts being forced to cover by higher gold [prices]. The gold ETFs have been drained. Using the largest as an example, GLD's gold holdings peaked at 43.5 mil oz in Dec-2012. Now it's down 51% to 22.3 mil as investors fled the metal. But where did the ounces go? They didn't evaporate. The ounces were among those continuing to be [exported to] China.
> 3) China is building a case to be designated a Reserve Currency by the IMF, perhaps as early as in Nov-15, and be included in the IMF's Special Drawing Rights (SDR) basket. Reserve currencies have the exorbitant privilege of being able to print the money to pay their debts. Now only four, US Dollar, Euro, GB Pound and Yen, their respective SDR weightings are 42%, 37%, 11% and 9%. [IMF research papers] suggest China would join at ~15%, which would take some from each of the existing, with the Dollar giving up the most or ~6 of its percentage points. Over time, Central Banks would adjust by selling Dollars for Yuan/Renminbi and because gold is priced in US dollars, as the dollar slides, gold would rise.
> 4) The [gold mining companies] themselves have tightened their belts and benefited from [falling costs of production]; oil is down 50% and the currency of every resource nation is 15-30% lower versus the dollar, so non-US miners' [wage and materials costs] have fallen to make the stocks more attractive.
> 5) US stock markets are toppy and vulnerable to a fall lower.

Energy

In spite of the strength of the March and late August rallies, we believe crude oil prices will show weakness for at least the next few months, due primarily to:

1) Escalating market share "war" – exporting countries compete with each other for market share, maximizing production at the expense of price. The main protagonists in the drama are Russia and Saudi Arabia, but Kuwait and the UAE are also contributing to the issue;
2) The inevitability of a return of Iranian exports to the world market;
3) The maximization of production by smaller OPEC and African producers to try to sustain cash flow essential to the operation of their governments; and
4) The continuation of technological innovation that will help US shale producers to lower costs (and thus maintain higher outputs at lower prices than had been possible in the past).

Mitigating those bearish factors is one of the most important maxims of supply and demand economics: "the cure for lower prices is lower prices," i.e. demand has stayed strong in relation to slowing worldwide economic growth. Chinese growth may have slowed, but with 6.9% GDP growth in a now very large economy, China consumes more and more hydrocarbons. We believe that producer/exporter supply pressure will trump growth with respect to price until next spring, when winter demand effects and supply shutoffs due to price could change the market's dynamics.

We expect natural gas prices to stay in their depressed state as a growing El Nino weather pattern will keep most US winter temperatures relatively mild, leading to less natgas usage and no help in clearing out high storage and plentiful flowing supplies.

Bonds

As shown in the Bonds section in Third Quarter Market Conditions, we believe the bond market is bifurcated and may become more so, depending on developments in worldwide economic situations and increasing concerns about growth.

We have been bullish on longer-term Treasuries, and while they have been volatile, we believe they:

1) offer safety first and foremost,
2) are a good hedge against financial upset (around the world) because they are still seen as one of a very few safe havens,
3) yield over 2%, and
4) will benefit as a "go to" investment when investors realize how worldwide economic growth (and US economic growth – not immune to the slowdown) is dropping or possibly turning negative in the next couple of quarters.

Meanwhile, high-yield or junk bonds, which have benefitted so much in the past couple of years from falling interest rates and easier credit terms, have dropped significantly from summer highs in spite of recently lower Treasury bond interest rates (on which most corporate bond interest rates are based). This is signaling a larger and larger concern for economic growth and the outlook for weaker credits persists.

Other Markets

Currencies continue to be a major area of our focus, and we continue to think that the US, with the strongest economy in the developed world, will continue to attract capital, leading to a stronger US dollar. This means weaker currencies against the US dollar, which will be a continuation of trends from this year and last.

We continue to think the ECB will try to further stimulate Europe's economies by expanding their quantitative easing campaign before the scheduled September 2016 conclusion. **[Late note: Mario Draghi at an October 22, 2015 ECB meeting strongly hinted at an expansion of QE in the near future]**. We also think Japan, whose economy is now officially in recession with consecutive quarters of negative growth, will come up with new ways for further stimulus, most probably with another monetary campaign.

With Canada's elections giving power to the Liberals for the first time in a decade, we may also short the Canadian dollar. We continue to think currency investments are an attractive way to express our investment theses, and we continue to look for new positions for our portfolios.

Kanos Quarterly Commentary

Questions for the Portfolio Manager

We try to include a section periodically where we incorporate investor questions and our answers in a Q&A/interview format in order to give you a better idea of our current thought process and portfolio management moves.

Q: Were you surprised the Fed did not raise interest rates at their mid-September meeting as they had warned they were probably going to do?

Kanos: We were not surprised the Fed did not raise interest rates (as we predicted in last quarter's report). However, what DID surprise us was the market's reaction to the Fed's inaction/policy statement. In our minds, the Fed had communicated ad nauseum about their reliance on economic (and market) data to use as rationale to raise or stay with current rates. In addition, the Fed Funds futures market, which companies use to hedge short-term interest rate exposures, was signaling only

an approximate 30% probability of a September rate hike. However, when the decision to not raise rates was announced and the key paragraph below was included in the Fed's statement (showing the Fed's now close-monitoring of global economic and market factors), the markets' reactions (after an initial spike upward) were to sell off, followed by a very large sell-off on the subsequent day. The key paragraph contained these sentences:

> "…**Recent global economic and financial developments** may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term…the Committee continues to see the risks to the outlook for economic activity and the labor market is nearly balanced **but is monitoring developments abroad**." ***[Emphasis ours – KS]***

We believe the Fed has been forced to pay attention to global economies and markets due to the Fed's machinations in monetary easing (which lowered the dollar against almost all currencies from 2009-2012 but has been strengthening the dollar since the tapering of quantitative easing starting in 2013). The recent continued rise in the US dollar versus almost all other currencies has led to a "de facto tightening of monetary policy" as export-dependent industries have slowed with the headwind of a very strong US dollar. The biggest example of this is the manufacturing sector, which has continued to slow during 2015, as represented by ISM manufacturing surveys (weakening over the last few months) and the regional Federal Reserve surveys (best represented by the Dallas, New York and Philadelphia Fed manufacturing-sector surveys released in mid-September) that showed massive slowing in those regions.

Again, we were surprised by the reaction of the markets to the Fed's decision: as shown in the graph on page 6, while gold, bond and stock markets all rose on the initial announcement (shown as the three lines just after the "FOMC" marker), the stock market (as represented by the S&P 500 which is the green line) subsequently dropped and then sold off strongly in the subsequent Friday session. Meanwhile, gold and the 10-year Treasury (the gold and blue lines on the graph, respectively) rose on the news, extended and consolidated gains as the equity markets were sold, and then gained more during Friday's session. During August we had cut our equity positions and held steady in our gold and bond positions anticipating the Fed's decision. The fact that so many others chose to believe some Fed spokesmen that rates would rise **and thought that would be bullish for the stock market** still makes us shake our heads.

Q: Why did the market fall so far after what most would consider to be a dovish, stock market-friendly decision?

Kanos: In our minds, there are four reasons.

The first reason is because the Fed sees enough economic weakness in the US and world financial systems to hold off on what many see as a "miniscule" amount of tightening. Obviously, if the US economy is not expected to grow as strongly as people were led to believe by the Fed, then prior growth rates are now considered too high, and asset valuations will fall with newer, lower growth rates, taking down prices, especially stock prices. However, prior decisions to hold interest rates

"lower for longer" have generated gains in equity markets, so this change in behavior of the equity markets after a dovish decision is notable.

The second reason is because the Fed had been using "forward guidance" (what many have called the "jawbone standard") for communication, i.e. telling people they would give the market plenty of warning for a policy change, and market participants took the last few months' Fed speeches as that warning for a new policy. Thus, when the policy DID NOT change, that introduced uncertainty and doubt into investors' and traders' mind about relying on the Fed for guidance.

The third is because the Fed has explicitly seemed to have taken on a third mandate to go with its Congressionally-approved mandates of maximum employment and price stability; **global economic and financial stability**. The paragraph above from the answer to the prior question shows the change in Fed focus.

The fourth reason and most worrisome for the Fed is traders and investors have come to assume the Fed was orchestrating its moves and actually directing the US and US dollar-centric world economies. Pre-decision, the Fed appears to have told market participants that the Fed thought the US economy was truly strong enough to stand at least one rate rise (although, to be fair, the Fed has continued to say all decisions were ultimately "data-dependent" – a euphemism heard enough that many in the markets started to discount the impact of these words). **Now there is a plenty of doubt introduced that the Fed is not in control of the US economy and markets.** This belief has been a longstanding cornerstone of the post-2008 bull market narrative: that then-Fed Chairman Ben Bernanke and his committee cohorts skillfully directed the US out of the Great Financial Crisis with "just enough" monetary stimulus (although it took 3 ½ episodes of QE) to get the US on track for "normalization" – an economy that can continue to strengthen in the face of rising interest rates and absence of further monetary stimulus. With all the advance talk of raising rates and then not doing so, **the belief that the Fed is in control has taken a serious confidence hit.** Like the other two reasons above, this introduces more uncertainty and doubt into the markets, which generally means volatility, lower valuations and thus, lower prices for risk assets.

Not having "bought into" this idea of Fed omnipotence over an extremely complex US economy and financial markets, we have been positioned with fewer high-valuation holdings and higher allocations to Treasury bonds and gold investments, which happen to have outperformed stocks after the FOMC announcement. We believe these outperformances will continue in the future.

Q: The current bull market is already among the longest of all time. When do you think it will end?

Kanos: As stated above, we believe the bull market could continue through the end of 2015, but we also think that the May/July highs seen in various indices may be the ultimate highs. The bear case premised on weakening growth prospects and too-high valuations has limited gains in the market through 2015. The bull case's arguments of low interest rates, high corporate profit margins and a still-growing US economy are starting to lose their power to propel the market higher.

Q: When do you expect the Fed to raise interest rates and how do you think the stock market will react to the first rate hike in almost a decade?

Kanos: We have maintained that we believe the Fed will not raise interest rates until at least 2017. We believe the US economy is currently slowing to the extent that it will react badly to a rate hike. We also believe that with a majority of Democratically-appointed or -leaning members on the FOMC, they will not raise interest rates in front of the Presidential election in which a Democrat (Hillary Clinton) is widely seen as the front-runner, lest they be blamed by the Democratic establishment if she loses after a rate hike further weakens the economy. Thus, we believe they will have to hold off until at least early 2017. The complication at that point is two-fold: 1) a large amount of junk bonds must be refinanced starting in 2017, and the rollover risk to this large category of debt supporting a large number of US companies will be threatened by early 2017 rate hikes, and 2) there will be a larger chance of a recession after so many years of growth (albeit slow growth), which would be exacerbated by a Fed rate hike. So we are actually unsure about when they would raise rates for many years looking forward, an environment in which we believe our portfolio mix of precious metals and resource stocks, long-term Treasuries and US multinationals would thrive.

Q: 2016 is a Presidential election year and rhetoric on both sides is heating up. How does the upcoming election impact your equity market outlook?

Kanos: We believe the election rhetoric will impact only certain sectors in the stock market, but we also believe that the volatility will rise in general for the stock market as uncertainty builds from the election. As we have seen in the past month, leading candidates' opinions could affect the stock prices for certain sectors: in September, pharmaceutical and many biotechnology stocks went down after candidate Clinton said in a speech that she thought drug prices (especially specialty drug prices) were too high and that she would do something about that if elected President. In addition, we believe that candidate Sanders rhetoric against Wall Street could hurt the stock prices of financials if he earns more support or Clinton has to move more towards his stances to try to gain some of his supporters. Meanwhile, exporters and energy companies could be hurt if candidates on both sides continue to talk about trade problems with other countries and continue with the ban on oil exports. Volatility should increase if the leading candidates on both sides don't become obvious front-runners, and once each political slate is set, unless one is a clear front-runner, we believe the stock market will repeat the August-September volatility seen this year.

Q: Where around the world do you see the most opportunity in markets?

Kanos: We were invested for many months in 2014-2015 in Japan and European stock markets (hedging out currency risk) because we thought their central banks' monetary stimulus measures would outweigh their weakening economies in determining stock prices. While we still believe ongoing (or possibly increasing) monetary policy will be coming forth from the Bank of Japan and the European Central Bank, we think that economic weakness in both regions will trump monetary policy with respect to stocks, i.e. we don't think stocks provide the opportunity for the downside risk caused

by failing economies. Thus, we believe that US stocks, select Asian stocks and multinationals will be where we continue to focus our investments, although we are still bearish generically on "Emerging Markets" because we believe the strong US dollar will continue to hurt their economies through depressed oil prices (for exporters) and high cost dollar-denominated imports.

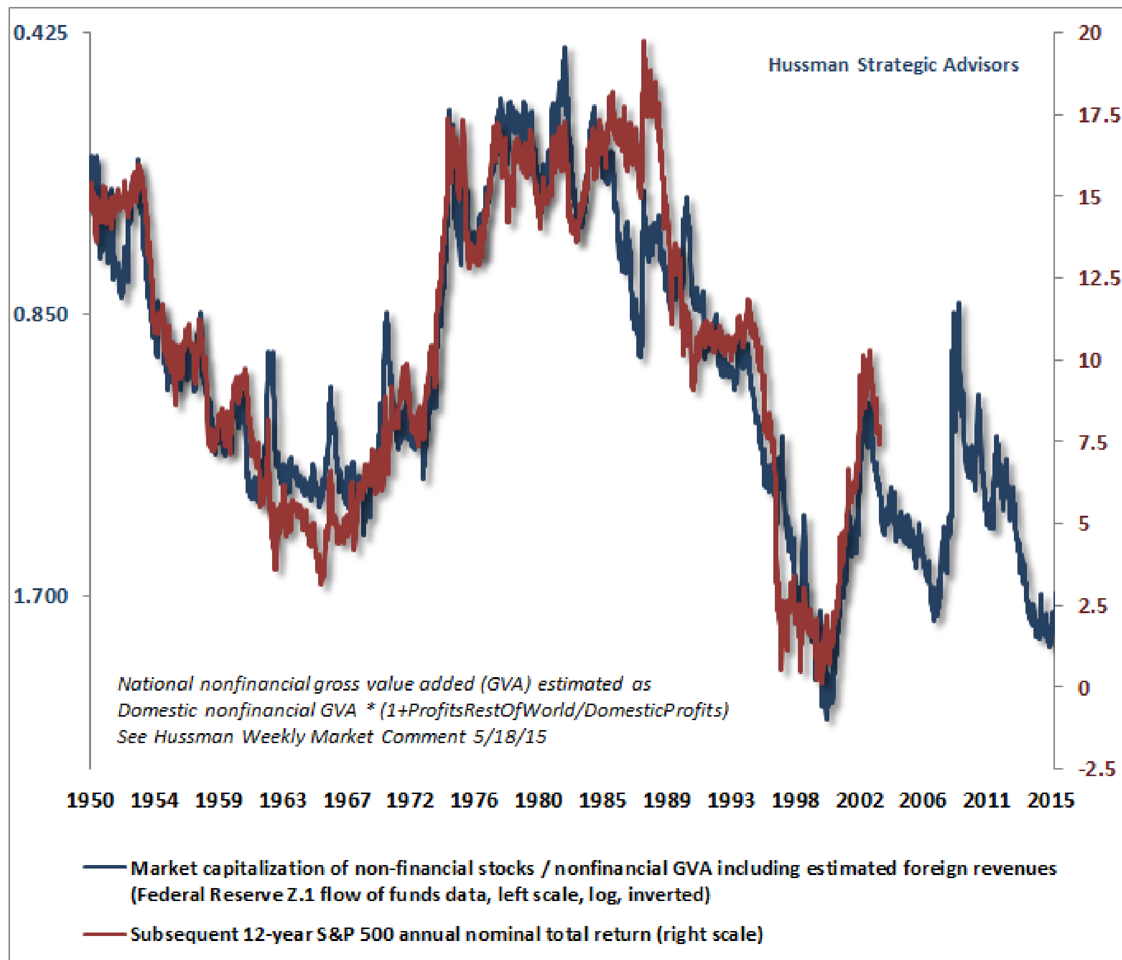
Q: The average return on the US stock market since 1926 is about 11%. Do you expect to see returns like that in the future? What is your expectation for stock market returns over the next 1-3 years?

Kanos: These are very difficult questions to answer, but we have our investment framework from which we can form an opinion.

First, we believe that there are a number of factors that have happened over the past 20-40 years which will almost certainly not be duplicated, leading to lower investment returns than the referenced amount above. A quote from 3rd Quarter Commentary from research firm Horizon Kinetics sums up this point well:

> "[T]o be mindful of the foundations for our here and now, three major stimulative factors in U.S. corporate profit growth of the last 30+ years will not be repeated:
>
> "[I]nterest rates cannot repeat their 13% point decline from 1981 (nor their boost to the valuations of real estate, venture capital, [and stocks]);
>
> "[T]he 25-year mercantile surge by America's blue chip consumer products manufacturers into formerly geopolitically unavailable markets such as China (Communism's dying gift), beginning with the 1990 Shenzen McDonald's, has spent itself; and
>
> "[T]he 40-year+ era of broadly stimulative government deficit spending – at least at the accustomed rate – is over. How, then, can the S&P 500 earnings grow at the historical corporate profit growth rate of the past 30 years, which – just to keep it real – was all of 4.7%, anyway?"

Second, the work of John Hussman of the Hussman Funds (data-focused former finance professor who runs a mutual fund company) has been emphasizing for months the predictability of future returns based on current valuation multiples. In the chart below from his Weekly Market Commentary of 9/28/2015, he has graphed **valuation versus past results**. The valuation is measured by market capitalization of all US companies (as presented by statistics produced by US Bureau of Economic Analysis) divided by GVA (which is US GDP less taxes and subsidies). This measure of valuation, he has graphed against the S&P 500 **lagged by twelve years**. **The fitting of the two series is remarkably tight, showing a very strong correlation between today's valuations and average returns for the next twelve years**. The graph shows that we should expect the S&P 500, dominated by large technology and consumer discretionary stocks, **to return about 1.5% annually for the next twelve years.** That is why we have concentrated our holdings in companies that have not performed as well lately and will far outperform this forecast in the next twelve years.



Thus, our expectation for the next 1-3 years would be very low or possibly negative for the S&P 500; however, **we believe owning non-S&P 500 stocks or underperforming S&P stocks in the US, plus international stocks, bonds and currencies, will allow us to far outperform these meager expected returns.**

Q: What is the biggest risk to the stock markets right now?

Kanos: Notwithstanding the current October rally, we believe any further growth scare or unexpected moves from the Fed (or even formal communication like Fed minutes) could cause more selling, similar to what we saw in August. The problem is that so many fund managers (especially hedge fund managers) have performed poorly this year that they have gotten more and more aggressive as the market started to rally (and are buying current performers to try to gain future performance); if the market goes into reverse, these managers tend to sell stocks quickly, which could add to selling pressure and cause a panic. Current examples of this are shown in companies that miss or beat earnings. Companies worth tens of billions of dollars or hundreds of billions of dollars are falling as much as 30% when they miss earnings and gaining 5-15% when they beat earnings. These mammoth-sized companies' expectations mostly don't change 30% when earnings are announced – but their

stock prices are punished that much when desperate fund managers panic out of the stock after these disappointments.

Q: If there is another big problem in the financial markets (like subprime in 2007-2009), where do you think it will occur?

Kanos: Again, this is a very difficult question to answer. If we had to predict a problem spot, we believe it would again start in the credit/debt markets, and then spread to the equity markets. We spend more of our time analyzing equity markets than debt markets, but we do think there are some trouble spots that could become much worse. First, there is the student debt market. We are not sure this is big enough to cause serious havoc in debt markets that could spread to other markets, like subprime did. Student loans are large and growing; many loans are non-performing as students have a hard time finding jobs, much less good enough jobs to allow them to pay back large loans. Second is subprime auto loans; loans are extremely easy to get for cars and trucks, and many are for as long as seven years (many times longer than one will own the vehicle) and for very little money down. We are concerned that these loans could sour as the economy slows further. Finally, we are concerned that high yield bonds are a large enough market that the bankruptcy of a large number of energy companies (if oil prices don't recover sufficiently to maintain debt service) will lead to funds needing to sell other holdings to service redemption requests, putting more and more pressure on a not-very-liquid junk bond marketplace.

Q: Concerning gold, what is your theory about why the above factors did not push gold up in price until August/September?

Kanos: We believe that two factors continued to weigh on gold prices: 1) lack of perceived need for gold and 2) the Fed's continued implied "promise" to guide monetary policy in a way that protects equity holders' portfolios. Addressing the first point, many large investors managed portfolios for large gains during the 1990s (as did we), and one big hallmark of the 1990s bull market was its implementation of innovations that led to many efficiencies in the US economy. This allowed new companies to grow very quickly as they supplied both the private and public sectors with technology and communications products that led to efficiency and greater productivity. This productivity led in many cases to lower prices for many products, which we call "disinflation" (price levels in general rose less than in the past due to lower prices for some products). Many called this "good deflation" where innovations (faster/more powerful computers, better software, the interconnectedness of the internet, online shopping, fiber-optic communications, small cell phones, etc.) helped make life and business more efficient. The Fed-ignited recovery of 2012-2015 is imagined by many market participants as having been this same type of economy where innovation and easy money led to new companies and a second 1990s-style tech boom. However, we think this notion was overblown, as most of the "innovations" were time-wasting consumer entertainment "advances" like social media (Facebook, Snapchat, etc.), phone apps (like Kim Kardashian: Hollywood or Angry Birds) and "better" ways to watch TV (Netflix, phone streaming, etc.). While these have created riches for their developers, we haven't seen the effects on the economy – **productivity has actually been negative during 2015** – and didn't believe this "disinflationary" story really held water. Inflation has been held back by WAGES – wages have stayed low because of the immense surplus of skilled and semi-

skilled labor around the world which has allowed employers to arbitrage labor costs by locating production around the world where labor productivity was high enough to justify very low wages. Thus, US workers lost jobs to Mexican workers, which then lost jobs to Thai/Malaysian workers, which then lost jobs to Chinese workers, which then lost jobs to Philippine workers. By moving production to minimize wage costs, wages have stayed low in the US (except for specialized and highly educated workers) while wages have risen in East Asia as demand for skilled laborers reaches its limits.

The Managers of Kanos Capital Management
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