KANOS
CAPITAL MANAGEMENT, LLC

Fourth Quarter 2015 Investor Letter

Portfolio Comments

The fourth quarter was propelled forward by a powerful October stock market rally, recovering from a re-test of August's lows. However, disappointing earnings reports, mounting concerns about falling oil prices and the arrival of a long-telegraphed Fed rate hike capped the late fall rally, and the market limped into the end of the year, with all US stock markets except the Nasdaq showing losses for the year. The quarter saw many stock market winners set marginal new highs, while commodity stocks, after a big rally in October, gave back all the gains by December due to a still-strong US dollar and the effects of further weakening of oil prices.

Our portfolios had similar performances to the US stock indices – outperforming in October, and suffering smaller losses in November and December. Our US Treasury bond and consumer staples positions provided stability throughout the period, while our materials and energy exposures led to upside volatility in October and downside volatility the rest of the quarter.

Fourth Quarter Market Conditions

October was the big "snap back" month after weakness in the third quarter. Markets were driven higher by increased conviction that the US Federal Reserve (the Fed) would not raise interest rates after a very weak employment report released on October 2nd. Most assets appreciated during the month, especially equities. Beat-up Asian and European indices led the charge higher, led by Germany's DAX index (+12%), China's Shanghai Composite (+11%), Japan's Nikkei (+9.7%) and Hong Kong's Hang Seng index (+8.8%). The S&P 500 was up strongly, rising 8.4% (including dividends), led by the Materials, Energy and Technology sectors, all up more than 10% for the month. Laggards in the S&P were the Utilities, Consumer Staples and Financial sectors, although all were higher for the month. Bonds were the only real losers for the month with UK Gilts down 1.5% and US Treasuries down 0.5%. Emerging markets bonds were 3% higher on averages, and riskier bonds, including US high-yield and European high-yield, were up between 3-5% for the month. Commodities were also higher for the month, led by crude where both West Texas Intermediate (WTI) and Brent were +3%. Gold and silver led the precious metals higher, +2.5% and +7%, respectively, while gold miners (represented by the ETF GDX) were up 9.1%, even after a late month swoon.

November was a more difficult month for most asset classes due to the late October Fed meeting announcement, which strongly implied the Fed would raise rates in December absent only some

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catastrophe. This reignited the rally in the US dollar, which put pressure on many financial markets during the month. The winners were the weak currency stock markets, namely European and Japanese markets, led by the German DAX (up 4.9%), the Pan-European EuroStoxx 600 (up 2.7%) and the Japanese Nikkei (up 3.5%). The big losers, predictably (because of the strong dollar) were commodities and emerging market stock markets: copper (down 11.6%), Brent crude (down 11.3%) and silver (down 9.4%) paced commodity drops, while Greece (down almost 10%), Hong Kong's Hang Seng (down 3.5%) and Brazil's Bovespa (down 2.5%) were stock markets that were down during November. The S&P 500 dropped mid-month but managed to recover to edge up 0.30% for November, led by the Financial, Industrial and Technology sectors. Losing sectors in the S&P were the Utility, Telecom and Consumer Staples sectors. Bonds were mostly flat for the month, with all US sectors gaining or losing only fractionally, except for high-yield, which was notably weak again in November. European bonds were slightly higher, helped by a weaker euro. Oil, as mentioned above, was notably weak, as inventories grew worldwide and weather was mild. Gold was weak as investors worried about the further effects of a stronger dollar on the precious metals; however, gold miners, while weaker, were stronger than the metal itself. Most notably, two superstar hedge fund managers, David Einhorn and Bill Ackman, were both down more than 20% year-to-date after poor November performances added to their prior woes – Einhorn due to soured positions in solar equipment maker SunEdison and coal/natgas company Consol Energy and Ackman's Pershing Square due to his large bet in now-disgraced drug company Valeant Pharmaceuticals.

December was mostly a down month for US financial assets. The big news for the month was the quarter point rate hike from the Fed during their mid-December meeting; the move had been extensively telegraphed and came in the face of deteriorating economic statistics (although December's job report was stronger than expected, even though unemployment is generally considered a lagging indicator not as useful for forward-looking economic forecasts). The US dollar was strong before the report but eased a bit after the rate hike, influenced by a stronger euro after the ECB failed to ease monetary policy during their December meeting. With all these economic events hitting markets, the S&P 500 ended down 1.58% for December (net of dividends). The S&P sector winners for the month were Consumer Staples, Healthcare, Utilities and Telecoms. The losing sectors were led by Energy (down almost 10% for the month alone, on the back of a new six-year low in oil prices during the month); other losing sectors included Materials, Financials and Technology. Bonds also had a losing quarter, led down by High Yield (junk) bonds, which set a new two-year low in early October and fell below that low in December. The high yield market was hit by falling energy bond prices but also a general weakening in prices of lower-rated non-energy issues. The decline was punctuated by the mid-December "gating" of some junk bond mutual funds, which were hit with too many cash redemptions for their relatively illiquid portfolios to absorb. Treasury bonds were slightly weaker during the month, pushed down by foreign central bank selling in support of their currencies versus the US dollar. Commodities suffered the worst again, led by the 17.8% drop in WTI, due to still-high worldwide production, mild weather in much of the developed world due to a strong El Nino weather event and a geopolitical game of "chicken" among large sovereign oil producers. Natural gas was the other big loser, down 4% for the quarter, but only after a massive 25% rally in late December. Precious metals gave back more of their October gains, with gold losing 0.8% for December, while gold mining stocks (as represented by the GDX ETF) ended down 3.1%.

Equities

As mentioned above, US equity markets rallied in October, but gave back some of the rally with weaker performances in November and December. The weak stock market performance in August and September did not set new lows when the low was tested in early October, so most sectors had very good quarterly performances: Healthcare, Technology, Materials and Industrials gained between 8-10% during the quarter, while Energy was the clear laggard (although with dividends, the sector was up 0.20%). The markets were influenced by the constant Fed rhetoric of raising rates at their mid-December meeting; when that came to fruition, stocks did not rally, recording a couple of bad down days, and limped into the end of the year, with a weak "Santa Claus" rally not able to propel the indices back to gains for the year (except the Nasdaq).

For the year, the picture was different. Large cap US stock indices were "held up" by some outperforming large cap stocks during much of the year (and this quarter), meaning most other stocks had a much poorer 2015 in comparison. The proof is in the statistics: The S&P 500 had a small loss for the year (-0.73%) but gained 1.38% when dividends are figured into performance; however, there were big sector winners and losers included in this performance. Winning sectors included Consumer Discretionary (up 10.11%, led by Netflix [+130%], Amazon [+119%], Home Depot [+28%] and Disney [+12%]), Healthcare (up 6.89%, led by Regeneron [+32%], Eli Lilly [+21%] and Bristol-Myers [+16%]) and Technology (up 5.92%, led by Google [+47%], Facebook [+33%] and Microsoft [+19%]). The Consumer Staples sector was also up during the year. Obviously, the Energy sector was the big loser, down 21.12%, net of dividends, as crude plunged 30.5% for the year. However, all other S&P sectors not mentioned above, were down for the year, with Materials (-8.38%), Utilities (-4.85%), Industrials (-2.53%) and Financials (-1.53%) all showing losses, even with dividends included. The telecom companies fell for the year, but with dividends included, showed a yearly total return of 3.4%. The widespread underperformance led to a year ending in '5' to have a loss for the first time since 1875 (140 years!).

The bifurcation in performance of a relatively small number of large-cap growth stocks versus virtually the entire rest of the market characterized the US equity market, most notably in the fourth quarter. Growth stocks beat value stocks in 2015 by 9%, although valuations on the large growth stocks that powered this performance are up to around the same valuation levels near the 2007 high and just under the valuation extremes seen in 1929 and 2000. Even veteran, successful stock pickers had poor years, with the average hedge fund down 4% and Warren Buffett's Berkshire Hathaway down 11.5% for the year, according to Mutual Fund Observer. The outperformance is vividly illustrated in the following table from Morningstar of how US mutual funds performed during 2015:

Fund Category Performance: Total Returns

Data through 12/31/2015. Returns are simple averages.

Name	YTD(%)
U.S. Equity Fund	
Large Growth	3.60
Mid-Cap Growth	-0.95
Large Blend	-1.06
Small Growth	-2.42
Large Value	-4.04
Mid-Cap Blend	-4.78
Small Blend	-5.38
Mid-Cap Value	-5.40
Small Value	-6.70

ALL categories of stocks showed losses for 2015, except for large growth stocks. In fact, in an environment where large US stock indices showed just very slight losses (and the Nasdaq 100 index showed an 8.4% gain), eight of the nine style groups showed losses, and many showed significant losses. Almost two-thirds of S&P 500 stocks were at least 10% lower than their 52-week highs and almost 40% were more than 20% lower, just three weeks removed from the Nasdaq setting a new all-time high.

Such outperformance has historically resolved itself by those former outperformers falling back to more traditional valuations, although timing of this is uncertain. We believe our mix of value stocks and "growth-at-a-reasonable-price" stocks will produce attractive risk-adjusted returns in the future as mentioned below in the "Going Forward" section.

International markets were where the money was made in equities in 2015, led by a 10+% gain in the German DAX and 30+% gain in the Russian Micex index, although dollar investors saw much of those gains taken away in currency losses if they did not hedge the currency exposure in these investments. Even Chinese stocks ended the year "on the plus side," although these gains were from early 2015 and the turbulence of the summer crash in Chinese equities was never recouped during the fall/winter.

Energy

Energy continues to be a "battleground" among large sovereign producers and commercial companies around the world competing for market share and cost reductions while trying to weather deficits/losses. The collateral damage is mounting as small producers continue to suffer and are starting to go bankrupt.

Saudi Arabia continues to be the focus of the crude oil markets, maintaining its production at high levels (greater than 10 million bbls/day). The surprise is Russia, which has been able to maintain (and even slightly grow) production levels above even those of the Saudis. Combine these two producers with the increasingly desperate African producers (Nigeria, Angola, Algeria, etc.) who cannot sell enough oil at these price levels to produce enough cash to maintain their economies for long, with ascending Middle East producers Iraq (currently producing 4.4 million bbls/day, a 26% y-o-y rise) and Iran (planning to raise its embargo-limited production from 0.5 million bbls/day by at least another 0.5 million), and you have the recipe for prices to have stayed below $40/bbl for the majority of December, especially since worldwide storage is almost 10% above median levels for this time of year. These conditions have led WTI crude oil to trade as low as $34.53/bbl in mid-December, closing the month and year at $37.04/bbl. The legalization of WTI for export in mid-December contributed to WTI and Brent crude trading at price parity for the first time in a couple of years.

US natural gas suffered during the warm El Nino early winter, keeping storage at capacity far later than normal and driving prices down to multi-decade lows. Natgas prices plunged from an October high of $2.40/MMBtu to a mid-December low of $1.71/MMBtu before the final arrival of cold winter weather caused a short-covering rally which pushed prices back up to $2.337/MMBtu at year's end. The large amount of available production, combined with a strong El Nino warming event, continues to limit natural gas prices in the short and medium-term.

Bonds

As mentioned above, bonds were where a lot of the "action" occurred during the fourth quarter, centered on December's "gating" of a number of high-yield funds. The continued deterioration in the credit of CCC and unrated junk bonds during the fall (obviously headlined by a number of energy issues facing or filing bankruptcy) led to lower prices for almost all CCC rated bonds (energy and non-energy alike). Accordingly, investors dumped investment funds which held these very high-yielding and risky bonds. When the illiquidity of this end of the market reached a crescendo in mid-December, these bonds were not able to be sold, leading managers to suspend the ability of investors to pull cash out of the funds until more reasonable prices could be found for the low-rated bond holdings. In many cases, managers were forced to sell higher rated bonds (BB and B rated) to raise cash for redemptions in even large, liquid funds in which investors wanted to redeem their investments. This redemption surge even hit investment grade funds, which underperformed for the quarter. <u>The implication is the junk bond mutual funds are probably weaker than earlier in the year, having sold their better credits to meet redemptions and holding worse credits that are hard to sell.</u>

Treasuries also underperformed, buffeted by the Fed's threat to raise short-term interest rates (which they did at their mid-December meeting) and the selling of long-term US Treasuries by many foreign countries and their central banks as these sellers attempted to defend (or at least slow down the fall of) their currencies in the face of a strong US dollar. Once the rate increase occurred, the US Dollar strength subsided some and long-term Treasuries rallied into the end of the year, although they still ended with small losses.

2015 was described by market research guru Jim Bianco as "the year when nothing worked." He has a point in that US stocks, US bonds, commodities, oil and gold all fell for the year. The power of the printing press (internationally, led by the ECB and Bank of Japan) led investors to put money into assets to be bought by these central banks, as European bonds (and Japanese stocks) both had relatively good performance years, with European sovereign bonds (and even some Emerging Market bonds) showing positive returns for the year.

Precious Metals

The precious metals gave back their large October gains after the Fed made it plain that the FOMC would be raising interest rates in December, with gold falling to $1045/oz in early December. It re-tested that low just after the Fed raised interest rates, but held and rose to finish the year at $1,060/oz, down 10.4% for the year (most of which occurred in July). Silver's price action followed gold's, finishing the year at $13.80, down 11.7% for the year. The majority of the metals' sell-off happened in June/July when traders thought the US economy was strengthening and the Fed was going to raise rates at its late July meeting. Gold's late autumn swoon also preceded the expectations of a rate hike (which happened this time). Historically, precious metals have performed well during rate hiking cycles, so the Fed's actual raising of interest rates will almost certainly mark the death of the bear market in gold.

A highlight of the year was the performance of two gold mining stocks we owned: Agnico-Eagle Mines and Detour Gold Corporation were up 6.8% (plus dividends) and 27.7% for the year, respectively. However, a number of other miners performed poorly, sending the gold miners, as represented by the Market Vectors Gold Miners ETF (GDX), down sharply starting in June on the fear of Fed interest rate hike fears, as noted above. However, as shown in the chart below, the GDX fell just below the $13.00 level in July/August and stayed at or above those prices, showing a real basing of the gold miners, even as gold hit a new low in December. In many cases, the gold miners lead the gold price in direction, so this is more evidence that the precious metals complex is bottoming and heading into a new bull phase.

Other Markets

Currencies were where the other "fireworks" occurred during the fourth quarter. The ECB has been communicating the lack of growth in European economies and their intent to add stimulus to try to further "kick-start" economic growth. At their December 3rd meeting, the ECB announced their intention to extend quantitative easing by at least six more months from its stated September 2016 endpoint, but they did not increase the monthly amount (from €60 bil/mo.) or lower interest rates, both of which the market expected. This led to an immediate 5% rise in the price of the euro, causing much havoc in European markets since many investment managers felt ECB President Draghi had communicated clearly that all three changes would occur. A 5% move in any currency is a lot, especially in one day, and in one of the three major currencies! It caused repercussions for weeks and forced President Draghi to offer more dovish commentary for days after the initial announcement.

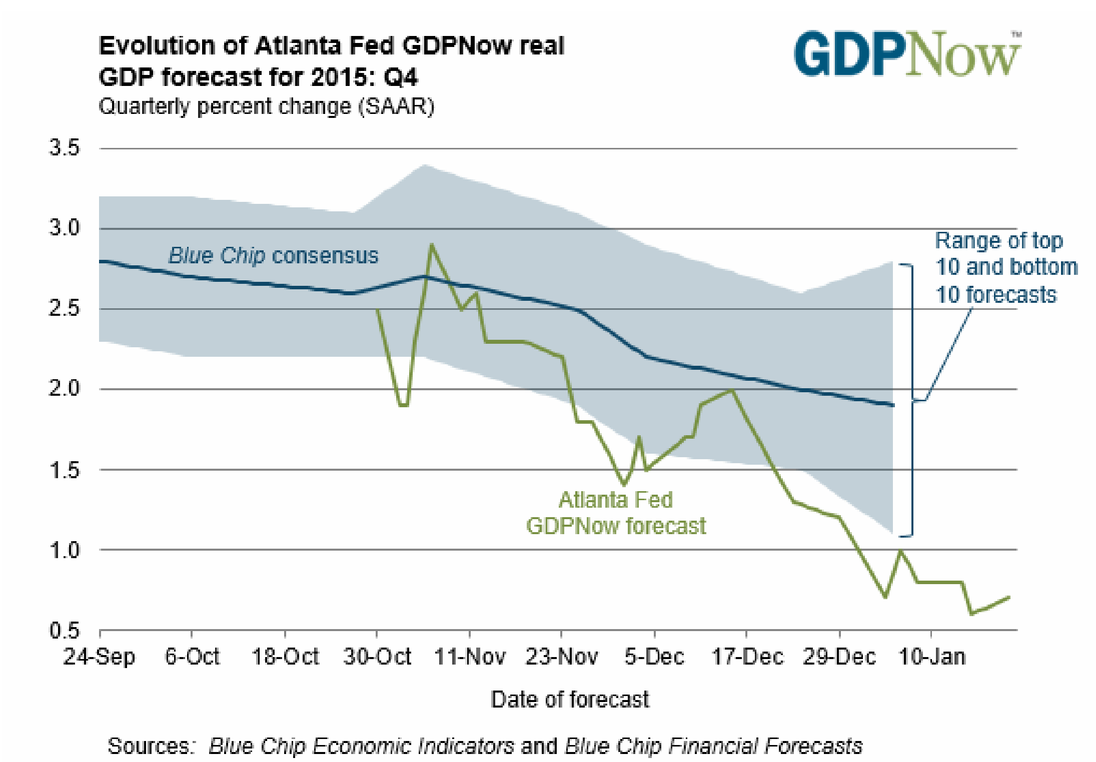
The other currencies that caused concern during the fourth quarter were the Russian ruble and Saudi riyal. Both were under pressure from low oil prices, and the ruble fell back near levels reached when sanctions were imposed on Russia by the OECD nations after the takeover of the Crimea and initial fighting in eastern Ukraine. The Saudi riyal is pegged to the dollar, but the Saudis had to intervene more and more in currency markets to keep the peg intact as capital started to leave the country when oil prices continued their plunge.

Going Forward

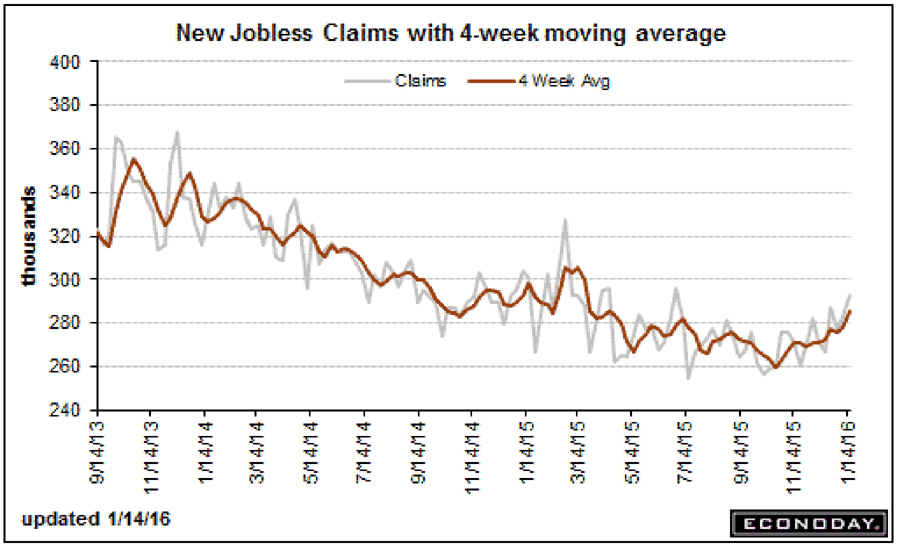
Economy

At press time, the economy has shown continued weakness in economic statistics and industrial surveys. Meanwhile, unemployment numbers have continued to show improvement and much of the financial press (and seemingly the Fed economists, too) continue to think the economy is on firm footing. However, when many signs point to that premise being too optimistic – below, we highlight some of the data that we believe shows a weakening economy.

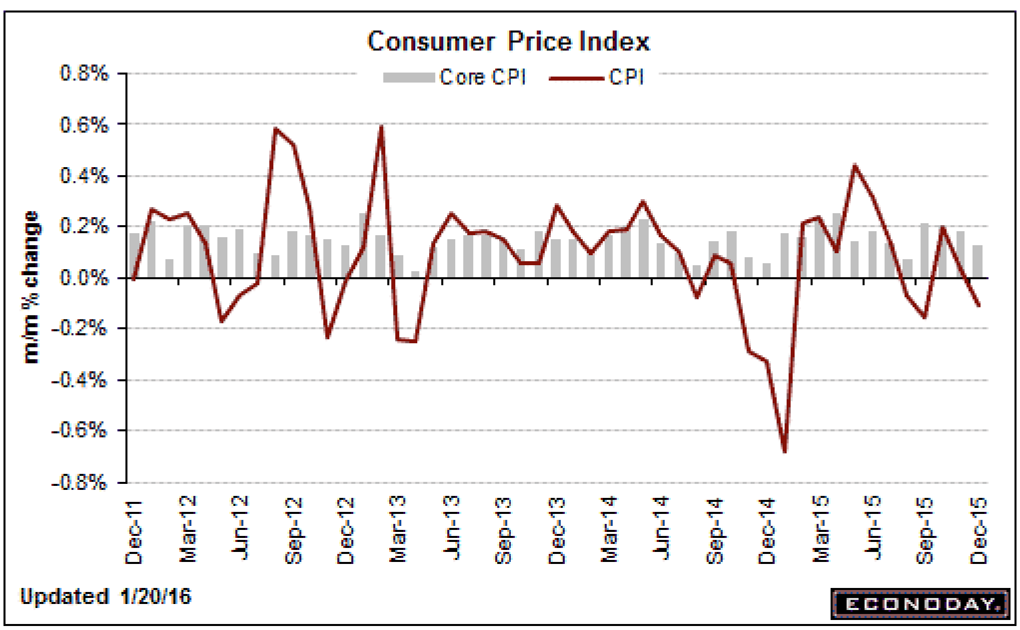
Atlanta Fed GDPNow Forecast Shows Slow Growth: One well-regarded economic measure is from the Fed's system itself! As shown in past letters, the Atlanta Fed has a model that tracks the measure of gross domestic product on a real-time basis, called the Atlanta Fed GDPNow model. This model has shown very good predictive power of final GDP measures in the past (far better than most Wall Street economists who are paid hundreds of thousands apiece but are not very good at forecasting economic growth, even just one quarter in the future). GDPNow, as shown below, is currently showing Fourth Quarter GDP only grew 0.7%, far lower than either the Fed in Washington or Wall Street's guesses ("Blue Chip consensus") of 1.9% – again far too optimistic.



Jobless Claims Rising: The government's Bureau of Labor Statistics releases a weekly measure of New Jobless Claims, which shows a much more current snapshot of the US labor situation than the monthly jobs reports. As seen in the chart below from econoday.com, jobless claims have continued to drop since 2009, but seem to have bottomed and are headed higher (the four-week average is the red-line on the chart and helps smooth volatility to better illustrate the trend of the data).



CPI Index Muted: Prices, as represented by the Consumer Price Index (shown in the chart below) shows muted increases in measured inflation (impacted strongly by dropping energy prices). Even the core CPI (stripped of food and energy prices) doesn't show a strong tendency to rise in the past few months.



Retail Sales/Industrial Production Slump: Another good snapshot of the health of the economy is the data that was released by the US government on Friday, January 15th. Retail Sales (not including automobiles) were expected to rise 0.2% for the month, but instead sales fell 0.1%. Retail Sales (excluding autos and gasoline) were expected to be up 0.4% but instead were unchanged. On the industrial side, US Industrial Production was expected to drop 0.2%, but it was actually down 0.4%. Business inventories were expected to be down 0.1% but were actually -0.2%. Finally, the Fed regional survey for New York state, the Empire Manufacturing Survey, was projected to have dropped to -4 (a "diffusion index" with negative numbers showing economic contraction and positives an expansion) but was actually -19.37! Thus, one day's releases showed four negatives and one neutral reading, which all were worse than expectations; these are the kinds of numbers that indicate recessionary conditions.

Slow GDP: The GDP (a kind of "temperature" of the business of the nation) is very slow, not accelerating in spite of years of Fed stimulus. Meanwhile, the two things that the Fed is supposed to be directly overseeing, employment and prices, seem to be weakening and are not in need of "reining in" with high interest rates.

However, contrary to what the points above are indicating, the Fed raised interest rates in December, and its forecast shows them raising rates <u>four more times in 2016 alone.</u> We believe the economy is weak, and that the strong dollar is acting as a further brake on US economic growth, possibly pushing us into recession. If the Fed continues to raise interest rates, we believe the US will enter recession in 2016. Remember, higher interest rates negatively affect a large amount of debtors through immediate changes like higher credit card interest rates or long-term rates, like higher auto loan and higher mortgage rates for houses. Higher interest rates also have negative influences on asset values, since one reason many assets have risen in price is low discounting rates caused by virtually zero short-term interest rates. As the market continues to adjust interest rates upward, asset values will come down and carrying costs will go up – not the thing that a weak economy needs to recover in the short run.

Equities

January 2016 has been the worst start of a year for the stock market since the 1920s (when good records started to be kept). The fall in the markets is due to a number of factors, which include slowing economies in the US, Europe and especially China; falling energy prices and the effects on producing companies and countries; rising risk concerns [represented by rising credit spreads and credit downgrades] and high valuations as a result of past years of stock prices rising faster than underlying fundamentals.

In the Commentary section below, we show a number of charts that illustrate recent market action and a number of valuation factors that illustrate changed price action after many years of bullish moves. The technical situation in the market has turned more bearish, although the extent of this correction is unknown but worrisome.

We believe the stock markets around the world will correct a lot of the excess valuation priced into stocks in recent years that is attributable, in large part, to easy monetary policies and monetary stimulus by the world's central banks. Meanwhile, the lack of fiscal reforms, due in large part to fractured political situations in much of the developed world, has left a situation in which economic growth is held back by too much government regulation, outdated tax regimes and too many competitors, many of whom have barely been kept alive by too-low interest rates (and would have closed or merged in regular business conditions). Thus, we think growth will be hard to come by until a more normal business cycle is established, meaning businesses and sectors need to be rationalized while productivity and innovation is rewarded in the US. Unfortunately, a recession is what will cause a lot of this rationalization to happen, but post-recession economic growth will hopefully pick up if the government can find consensus after the 2016 elections and help the economy with fiscal reform.

So, with the "soapbox speech" over, we think the stock market will continue to weaken over time until the Fed (and other central banks) decide they must provide more monetary stimulus, which should lead to a resurgence in the stock market. Unfortunately, we don't think it will help the economy enough to avoid a recession, although if the Fed reacts strongly enough (i.e. rescinds the December rate hike and invokes a new phase of quantitative easing [" QE4"]), it will probably postpone the recession into 2017.

There has also been pressure on US equity markets from overseas sovereign wealth funds ("SWFs") that invested their countries' excess oil & gas earnings over the years in diversified investments, including US stocks and bonds. Now that these countries are suffering from large deficits due to low energy prices, these SWFs have been selling some of their liquid investments to allow governments to fund their budget shortfalls. As oil prices fall, we expect to see this activity increase (which is one reason why we see oil prices and equity markets trading in lockstep so far in 2016). These SWFs will also no longer provide an almost constant bid in the market like they did from 2011-2014 when oil prices were over $100/bbl on average, thus robbing the US stock market of one of its past supports.

we see the stock market continuing to fall during the first quarter, punctuated with some strong bear market rallies (temporary gains in the markets), but erasing a large chunk of the 2012-2015 gains until the Fed feels compelled to intervene monetarily, which will give the market a large boost, at least for a time.

Precious Metals

As mentioned above, we feel like there are numerous indicators showing the precious metals complex has bottomed. Both gold and silver are higher for the year, although they have oscillated with the volatility in the equity and currency markets year-to-date. As far as the mining companies are concerned, so far in 2016, the pattern from late 2015 has continued, with those companies which did well in 2015 rising in 2016, and those which did poorly falling further in 2016.

We think the downward trend in economic growth around the world won't help the gold price immediately, but believe the emergence of new monetary stimulus will benefit gold and value stocks much more so this time around because we predict the growth that propelled growth/momentum stocks from 2012-2015 will not re-emerge, no matter how much monetary stimulus is produced, although it will help all stocks initially after its announcement/implementation.

Energy

There is so much to be said about oil prices, but ultimately we believe it comes down to this: oil is being used as a weapon in a global war among sovereign oil producers, namely Saudi Arabia, Russia and Iran as the major players. While there is a large dose of economics in why or why not oil should be produced, we currently believe this is a fight to the death where economics is not the main driver. Thus, we don't believe that we can judge oil price movements through economic eyes, which means that the economic players (oil companies, shale producers and smaller countries without large reserves) may cut back on their production some because they are losing money, but the large non-economic players will replace as much of that production as they can. In addition, the large amounts of debt that were used to finance exploration and production in the last few years (both privately and sovereign countries used tons of debt) means that debt-laden companies and countries must service debt payments, which leads to their producing as much as they can to generate cash flow for debt service, ultimately keeping prices lower than they might be absent this financial incentive. So "rational" producers with strong balance sheets may cut back some for economic reasons, political and debt-laden producers will continue to produce near maximum rates for political and cash flow reasons, respectively. Finally, stored oil is supposedly at the highest level (as a % of production) since the 1930s, meaning even supply/demand improvement can be met with selling from storage, further capping upward price pressures.

Thus, we are bearish on the price of oil, although there will certainly be rallies in the midst of this bear market (like we saw in March 2015 and are seeing right now). We still believe that without large production cuts, the amount of oil in storage and the mildness of the winter of 2015-16 mean that there is plenty of oil to cap a rally in price over the medium term. Only when one of the big players decides to stop the "market share game" and cuts production will prices be on the road to more permanent recovery.

Domestic natural gas also suffers from a large supply overhang and the mildness of the winter. The effectiveness of shale gas exploration and production techniques have led to large amounts of gas discoveries/potential production throughout the US, so there is also plenty of future production waiting in the wings. Thus, we are still bearish on US natural gas, and will continue to be at least through next fall, when we will see whether the production oversupply, overflowing gas storage and price dynamics have changed at all.

Bonds

We see the same forces that emerged in 2015 continuing in 2016: weakness in high yield bonds caused by flagging businesses (especially in the energy/commodity sectors) and some continued weakness in investment-grade corporate bonds as the economy slows, although some very highly rated bonds (AA rated bonds) could act like government bonds. We expect US government bonds to perform well (go up in price and down in yield) as investors look for safer havens to park capital. This strength will be offset somewhat by Treasury-selling by Asian countries as they try to slow down the fall of their currencies (currently China is doing this but we expect it from Hong Kong, South Korea, Singapore and others, including Japan) and from resource countries (as they try to replace oil revenues lost due to lower prices with wealth stored up over the years in US Treasuries). We believe a fair amount of international selling has already happened, but we expect much more buying by shell-shocked equity investors, "winning the battle" over Treasuries and sending them higher (and yields lower). Thus, we have added Treasury bonds to our portfolios in 2016 and could add more, depending on equity market conditions and Fed behavior.

International bonds are not attractive with the US dollar still gaining in value. If the Fed backtracks and re-starts monetary stimulus, we would expect to see a fairly strong move of money out of the dollar and into other currencies, which could make some highly rated bonds of European companies more attractive.

Other Markets

We have stayed short the euro because we believe their political and economic situations are ultimately not resolvable, and the ECB is the only thing that keeps the euro viable as a currency. In addition, Mario Draghi, after the most recent ECB meeting, seems to have re-established that the bank must increase its stimulus to the Eurozone by announcing they would move up the review of new monetary stimulus measures scheduled for June 2016 to early March.

The Japanese, while losing currency momentum to other Asian currencies (particularly China), have not shown a particular hurry to increase the monetary stimulus that drove the yen to 125/$ in 2015 but has retreated to 117/$ at press time. We have therefore redeployed our yen shorts into cash and bonds for the time being because the yen has traded opposite to US stocks during times of distress (thus hurting our short positions when US equities are weak).

The other resource currencies, like the Australian and Canadian dollars, look vulnerable to further commodity price weakness leading to further economic weakness, especially if China is not able to arrest their dropping growth numbers, but we have not found an efficient way to be short these currencies at this time.

Kanos Capital Management, LLC

Kanos Quarterly Commentary

Chartroom – The State of the Markets

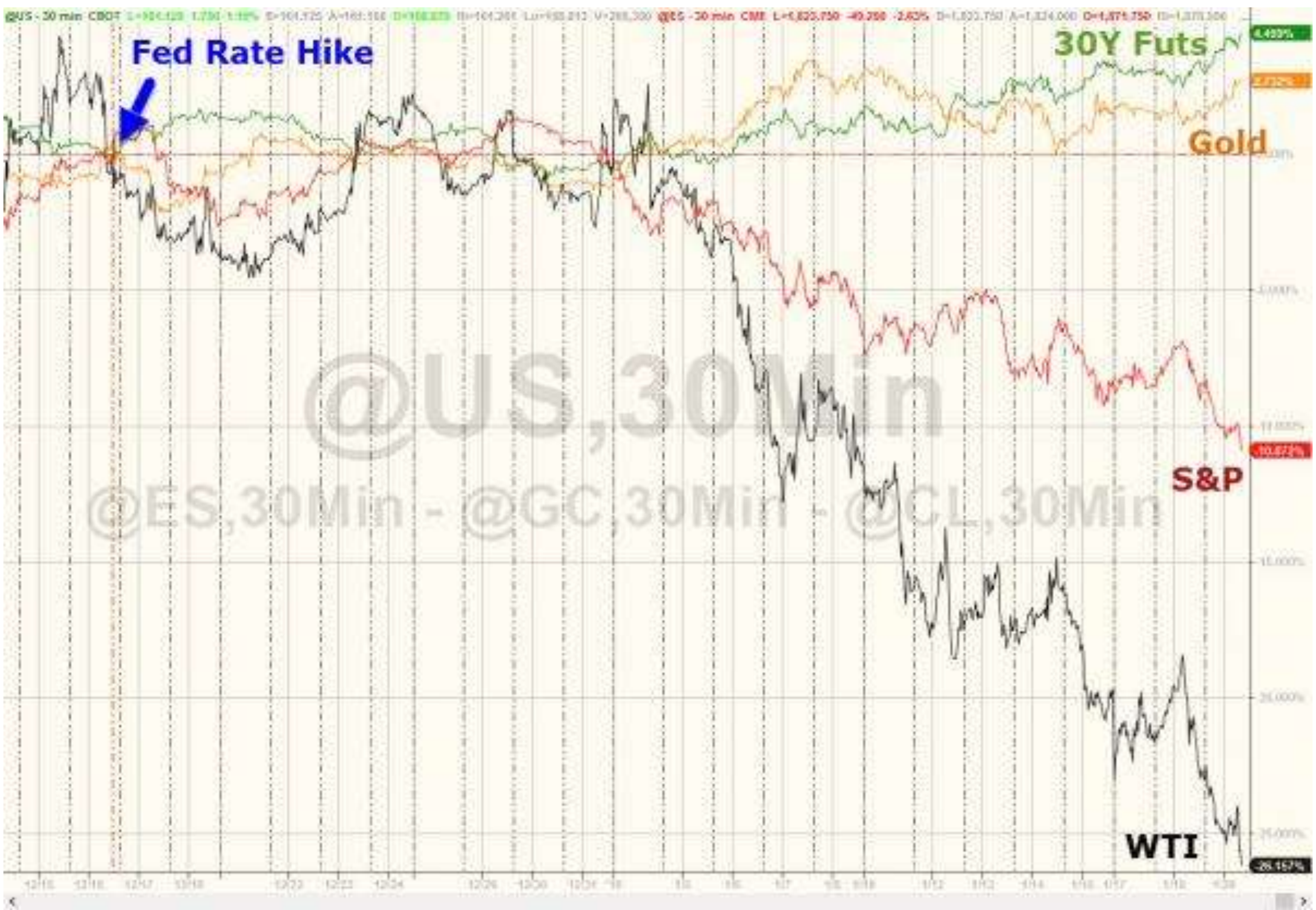
There are a number of charts and diagrams produced lately that help us analyze the past and present market actions that we believe will help us handicap the probabilities of future market actions. We present them below with some explanation on what they are and why we think they are important.

Very Poor Start in January 2016 – many times a precursor of the performance of the rest of the year: As mentioned previously, the S&P 500 had the worst performance in the first 2+ weeks of 2016 of any year since comprehensive records of the stock market were kept starting in 1926, as shown in the graph below.
Significance: In many cases, such violent moves take both a psychological and technical toll on the markets which could lead to further losses.

From Zerohedge 1/15/2016 “Black Friday”

Fed Policy Mistake: The following chart shows the price action of four benchmark financial assets since the Fed's decision to raise short-term interest rates in mid-December: The importance of this diagram is that the two safer, less risky assets on the chart, gold and futures on 30-year Treasury bonds, are higher in price (showing more demand for them) since the decision, while the riskier assets, large cap US stocks in the S&P 500 and WTI crude oil, show significant losses.

Significance: We believe this shows that markets believe that the Fed has made a policy mistake in raising rates, and the longer they keep their tightening bias, the greater the damage of higher rates and a strong US dollar on the US economy and financial markets.



From Zerohedge 1/20/2016 "World Enters Bear Market"

Stocks Tend to Follow Credit/Bonds: This chart shows the price action of stocks (as represented by the S&P 500 index ETF [SPY]) and high yield bonds (as represented by the iShares iBoxx $ High Yield Corporate Bond ETF [HYG]) since late 2014. High yield bonds often perform in line with stocks because they are both in line for claims on assets behind senior bonds. However, the price action of bonds often leads that of stocks, and the chart below shows their correlation through early May. However, high yield bonds started dropping after that and were joined by the S&P 500 at the August lows.

Significance: High yield bonds have dropped further in the late September (interim) lows, but the SPY has not yet fallen nearly as much. We are concerned that the SPY can drop further, especially since high yield bonds are continuing to drop.

From Zerohedge 1/15/2016 "Black Friday"

Energy Company Credit – Worse Than 2008/9: The following chart depicts the yields of energy companies' high yield bonds since 2000. Incredibly, with Treasury yields near 35-year lows, high yield bonds of energy companies have hit new highs, even higher than during the credit crisis during 2008/2009.

<u>Significance</u>: The credit situation of energy companies is the worst in more than fifteen years, meaning that it might not get better very quickly and that exploration/production companies are under extreme credit stress, most probably leading to a lot more bankruptcies that anticipated by the consensus.

From Bloomberg 1/14/2016 "WTI Leads Down Energy Bonds"

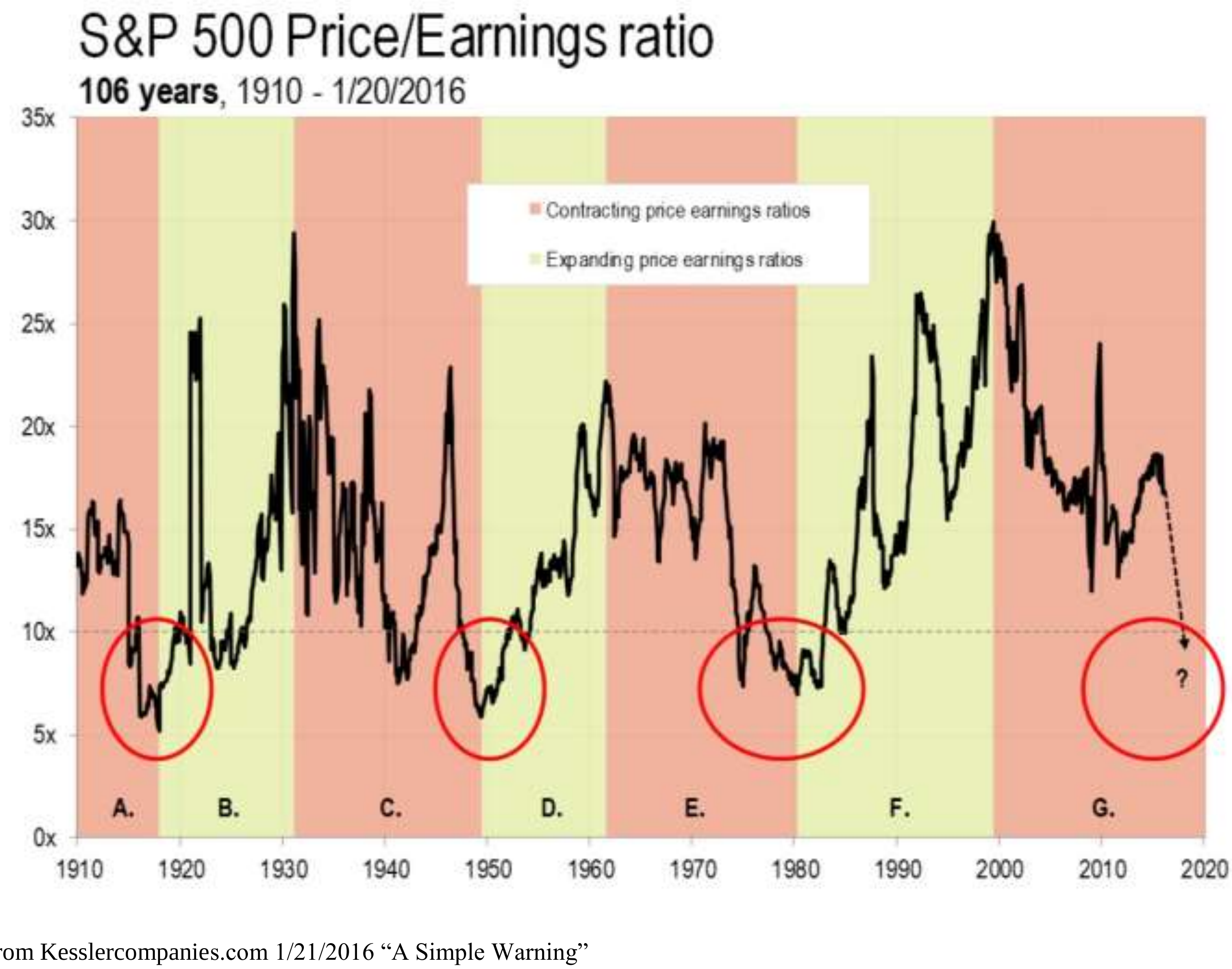
Stock Weakness a Worldwide Trend Since Late 2014: Negative momentum in US stock markets hasn't been a problem until very recently (i.e. highs were recorded in US indices during the summer of 2015 and as late as December for the Nasdaq 100). But as shown in the chart below, world stock markets as a whole have been dropping since late 2014.

Significance: We are concerned that stock market weakness has further to go as growth is difficult to find around the world, leading to lower valuations. Meanwhile, in a financially interconnected world (capital moves to where it can get attractive, risk-adjusted returns fairly quickly), market weakness can lead to panic, which can spread around the world (notice the drop in mid-August sparked by Chinese market weakness affecting all the world's markets) quickly.

From Bloomberg 1/20/2016 "Global Shareholders Have $27 Trillion Locked in Bear Markets"

Price/Earnings Ratios Find True Bottoms At Low Values: The next diagram shows the P/E ratio of the S&P 500 over the last 100+ years. Notice the shaded regions, with the light green representing long-term trends of rising P/E ratios (which correspond to structural/durable bull markets) while the reddish zones indicate downtrends in P/E ratio (coinciding with structural bear markets). The arrow on the very right side shows the ultimate direction of the trend in P/E ratios before a new bull market can start.

Significance: P/E multiples bottom out below 10x at the end of structural bear markets, which from a P/E perspective, we are still in (in spite of recent highs on indices over the past couple of years). **As the P/E multiple drops, the price of the stock or stock index usually drops as investors lose confidence in the company's/market's ability to generate growing earnings. Since the S&P 500 has had lower earnings for the past three quarters, falling P/E ratios are a real concern.**



From Kesslercompanies.com 1/21/2016 "A Simple Warning"

Regression To The Mean When Outperformers Reach Extremes: The next chart shows the extreme outperformance of high-growth momentum stocks that did so well after 2009 (the red and orange lines that then propelled the S&P 500 higher). JP Morgan, who produced this chart, opines that there was a bubble in growth/momentum stocks to the detriment of value and emerging market markets and currencies, which in many cases are commodity based (the dark blue, light blue and green lines). Not only did Fed policies help propel these stocks, but computerized/systematic trading systems (including trend-following, high-frequency momentum and volatility-based risk management systems) exacerbated the performance difference.

Significance: As momentum has started to reverse, highly-valued companies failing to meet heightened expectations have historically reverted to more traditional valuation levels, while bombed out underperformers have historically rebounded from their current very-low valuations. Since the large growth stocks have outperformed and represent a very large part of major US market indices, these indices could drop significantly as valuations regress toward the mean.

Figure 1: Relative performance since 2008 crisis

Source: J.P. Morgan QDS, Bloomberg.

US Stock Market Has Peaked; Recent Bottoms Were 54% and 70% Lower: BofA/Merrill produced this next chart using the equal-weighted Value Line Geometric Index (not cap-weighted, where large companies matter more). Using an index that equally weights all of its components (to get a better feel for the performance of the average stock), even the US stock market peaked in late 2014 and has been dropping since [compare to the World Stock Market chart four pages back – the 2015 portions of the charts look the same].

Significance: The last three peaks have all been at about the same level (around 500 on the index) and show the average stock could fall another 30-50% to match levels seen at the last two bottoms of similar valuations. The fall so far in 2015/16 is not even as bad as the Asian Crisis of 1997/8 when Asian markets and their effects on US markets and the economy were far smaller.

Chart 1: Equal-weighted US stock index already down 23% from highs

Note: peak-to-trough declines; Asia crisis = Apr'98 to Oct'98; Tech bust = Jul'99 to Oct'02; GFC = Jul'07 to Mar'09; 2015 high = Apr'15
Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg

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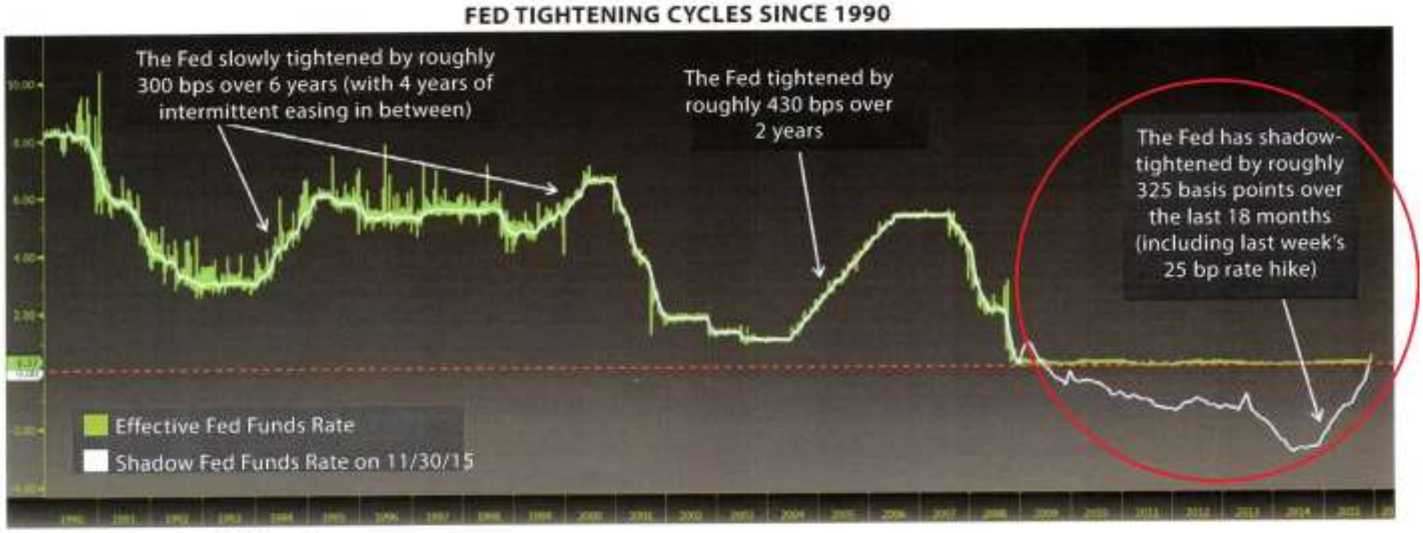
7.5 Year Cycle Analysis Shows Worldwide Stock Markets Could Go Much Lower: The next chart shows another study of the last three peaks in the market, this time using at worldwide index from MSCI, a Morgan Stanley-developed index that governs worldwide index investing these days. This study divides time into periods by 7.5 year timeframes and charts the index levels in green and black data points.
Significance: This study shows that if one believes in regular cycles in the markets, the investing world is at the beginning of an extreme down phase that has historically led to declines of at least 50% from current levels.

From Twitter @TrueSinews 1/19/2016

Tapering Is Tightening! This chart, from Evergreen GaveKal and Bloomberg, shows the plot of the Fed Funds Rate since 1990. The green lines show the actual Fed Funds Rate, which shows two interesting characteristics: 1) the rate was extremely variable around the target rate during the 1990s (left side of chart) and 2) the rate has been pegged at/near 0% since late 2008. Economists at the Atlanta Fed produced an analysis that shows what the "effective Fed Funds Rate" would have been when the real Fed Funds rate was pegged at zero but quantitative easing made credit cheaper by having so much money created through QE. The results, highlighted in the red circle on the right of the chart, show that QE pushed effective rates down near -3.0%. Since the end of QE3 in September 2014, the Fed's tapering of their purchases has led to higher effective rates, culminating in the Fed's December 2015 actual rate hike.

Significance: **The point of this chart is to show that the Fed has effectively been raising rates for more than eighteen months, not just in the past month! The effect of fewer and fewer QE purchases has "felt" like interest rate increases in past market cycles. Maybe that is why the market had effectively topped (except for a few large Nasdaq stocks) in the fall of 2014.**

FED TIGHTENING CYCLES SINCE 1990



Source: Evergreen GaveKal, Bloomberg

From The Evergreen Virtual Advisor, 12/23/2015

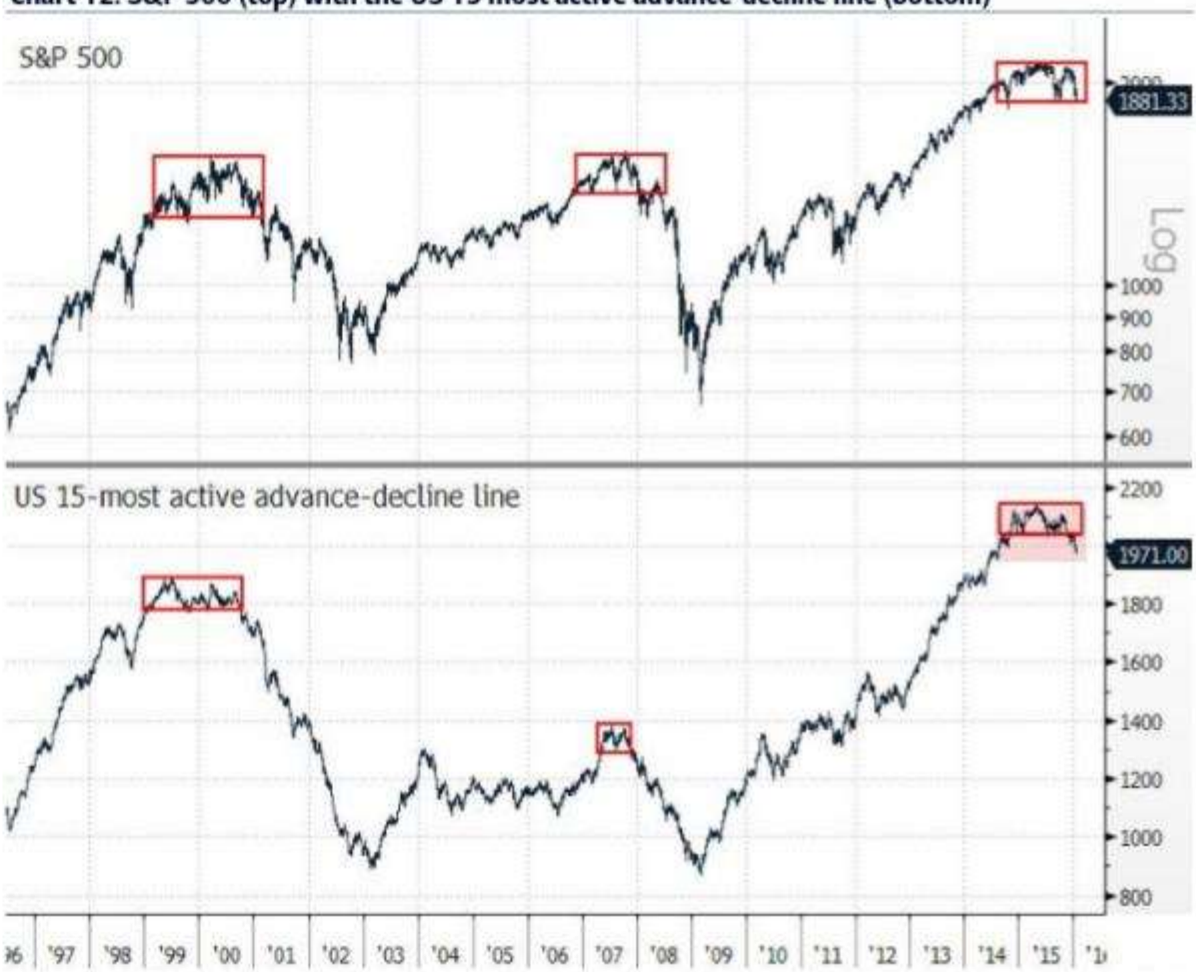
Earnings Growth Lead Stock Market Advances And Signal Market Downturns: This chart, from an article on Marketwatch.com, graphically depicts the growth in S&P 500 earnings per share (EPS) growth (blue line) graphed versus the S&P 500 index levels (black line). The last two market cycles are graphed, and EPS growth clearly peaks before the index peaks.

Significance: In the 2002-2009 cycle, the S&P didn't drop until earnings growth decelerated strongly. We are not seeing S&P EPS growth in a more pronounced downtrend, coinciding with weakness in the S&P index (right side of the graph). One might expect to see stocks weaken as earnings growth continues to weaken. Remember, the S&P 500 index peaked in October 2007, almost a year before Lehman/AIG caused extreme market weakness and ushered in the crisis that led to further big drops in the index.

"Earnings take a dark turn as profit warnings, sales misses mount" on Marketwatch.com, Jan 28, 2016

Stock Activity of the 15 Most Actively Traded Stocks Signals Market Tops: BofA/Merrill has produced a chart which compares the S&P 500 index with trading characteristics of active stocks to predict market tops. BofA/Merrill took the trading of the 15 most actively traded stocks at the time (in 1999-2000 these stocks were probably Cisco, Intel, Microsoft, etc., in 2007/2008 it was Bank of America, AIG, GE, etc., and in 2014-15 they included Amazon, Facebook, Google [now Alphabet], Netflix, Starbucks, etc.) and calculated the amount of days each rose (the advances) and subtracted the days each fell (the declines). Thus, adding the advances and subtracting the declines gives the 'advance-decline' line that allows you to see when stocks are rising (more advances than declines) and the opposite. This graph shows the last three peaks in the S&P 500 compared to the advances versus declines in the most active fifteen stocks. In both 2000 and 2007, breakdowns in the most active volumes preceded large drops in the S&P 500 index, with 2015 showing the same characteristics.
Significance: This study has shown that calculating the advance-decline line of the most active stocks is a leading indicator of a top in the index. As the red shading in the lower right part of the graph shows, the fifteen most active advance-decline line has broken below its box (which indicated a sideways pattern), which in past cycles has indicated the top in the index and preceded large declines.

Chart 12: S&P 500 (top) with the US 15 most active advance-decline line (bottom)



Source: BofA Merrill Lynch Global Research, Bloomberg

The twelve charts presented show a concerning set of circumstances in the financial markets and lead us to believe that there is a high probability that the current weakness is the early stages of a bear market. The real question is how far this bear market takes stocks.

We believe the declines in many overvalued stocks will continue and combined with continued poor economic readings, will force the Fed to give up its rate rises and bring on easing, first in lower rates and then in a new program of quantitative easing – QE4. That will cause stock markets to rise, but we are concerned that the lack of growth in the world will show QE4 to be transient in helping, leading to a market low that follows the QE4 "lower high". We have positioned portfolios in a more defensive manner to minimize risk and hopefully losses, while retaining underperforming assets that should react better going forward (value stocks and precious metals) while keeping capital in Treasury bonds which will provide stability, safety and some yield.

Meanwhile, we are poised to keep tabs on markets worldwide and valuations of a wide variety of stocks and bonds, looking to take advantage of values in the market and re-establish the growth of wealth in our portfolios.

The Managers of Kanos Capital Management