KANOS
CAPITAL MANAGEMENT, LLC

First Quarter 2016 Investor Letter

Portfolio Comments

The first quarter was a "tale of two halves" – the equity (and oil) markets fell from the first trading day in January through mid-February, then gained most of the losses back over the rest of the quarter, with most indices ending up with small gains or losses. While economic weakness was consistent through the period, the US Federal Reserve (and other central banks including the European Central Bank and Bank of Japan), all either eased monetary policy further or switched from a tightening bias to a neutral bias, thus helping reignite world equities. The big winner was gold (and gold investments), which rose the most since 1986, while growth stocks, led by Amazon, had losses for the first time in many quarters. Our portfolios benefitted from their holdings of precious metals, US Treasuries and more defensive Consumer Staples stocks. Most of these investments outperformed in January, moved up strongly in February and rose further in March. Our under-exposure to Financials, Energy and Technology helped us outperform most large indices. We believe our positions will continue to outperform in a 'down' market and gain in an 'up' market, an environment characterized by high-valuations and uneven economic growth.

First Quarter Market Conditions

January started the year with large drops in the US stock markets in conjunction with falling oil prices, which seemed to lead equity prices during the month. The S&P 500 was down 5.07% (-4.96% after dividends) while oil, represented by West Texas Intermediate (WTI), was down 9.23%. Brent crude was down only 6%. US stock markets were led down by the Materials, Financial and Healthcare sectors. There were some pockets of safety as the Telecom, Utility and Consumer Staples sectors all managed gains for January. Amazingly, US stock markets were some of the best performers: China's Shanghai Composite was -22.6%, Italy's FTSE-MIB was -12.9%, Germany's DAX Index -8.8% and Japan's Nikkei was -8.0%, to name a few. The winners for the month were 1) precious metals (gold +5.9%, silver +3%), bonds (10-year US Treasuries and German Bunds +3%) and other European sovereign bonds (+1-3%). High yield bonds, both US and European, were notable laggards, -1+% for the month. Commodities as a whole were also quite weak, with the Reuters-Jefferies CRB index -5.40% in January. The US dollar was strong once again, higher against the Euro (+0.3), the yen (+0.7%) and the British pound (+3.5%).

February started weaker for the markets and commodities, but a mid-month rally led most markets back near unchanged by month's end. The S&P 500 was just -0.13% in February, buoyed by gains in

the Materials, Telecom and Industrial sectors. Financials, Energy and Technology were weaker for a second straight month, showing the lack of strength in the leading sectors from the last couple of years. Gold and gold mining stocks were again the best performing assets this month, with gold rising just over 11%, silver up 4% and gold stocks up more than 33% for February (as represented by the GDX ETF). Bonds rose during the month, led higher by European bonds, US investment grade bonds, Treasuries (the 10-year ended the month yielding 1.74%) and even a small gain in high yield. Big losers for February included the Nikkei (down almost 10% for the month), Greek, Italian and Portuguese stock and most European bank stocks, all down more than 5% for the month. Oil rebounded during mid-month and finished February up 0.4% while other commodities, most notably corn and wheat, were very weak for the month. The US dollar dropped during the first half of the month, but recovered much of the drop by the end of February. The end of the month was characterized by slow but steady rallies in most financial assets.

March was another "bounce-back" month after the weakness earlier in the quarter, driven higher by continued stabilization in oil prices and the US dollar level as well as conviction that the US Federal Reserve (the Fed) would not raise interest rates again anytime soon. Most assets appreciated during the month, especially equities. Beat-up emerging markets indices paced the gainers, led by Brazil's Bovespa index (+17%), Greece's Athex index (+12%), China's Shanghai Composite (+12%), and Hong Kong's Hang Seng index (+9%). The S&P 500 was up solidly, rising 6.8% (including dividends), led by the Energy, Technology and Utility sectors, all up more than 8% for the month. Laggards in the S&P were the Healthcare and Consumer Staples sectors, although all sectors were higher for the month. Bonds showed much smaller gains for the month, although emerging markets bonds rebounded between 5-9% higher on average. US high-yield and investment grade bonds were up, but US Treasuries were virtually flat for March (as were developed Europe bonds). Most commodities were also higher for the month, led by WTI (+14%) and Brent (+9%). Only gold and corn were slightly lower for the month, but the gold miners (represented by the GDX ETF) were up 7.5% for the month.

Equities

US stock markets managed to rebound from January and early February losses to post modest gains for the quarter. While the earnings outlook did not improve during the first quarter (including expectations for the second quarter), the weakening of the US dollar and the subsequent rise in oil prices led to a rally in US and emerging stock markets, turning early losses into gains. The S&P 500 ended March at 2,059.74, returning 1.35% for the quarter (including dividends), but this does not show the disparity in results: gainers for the quarter included Telecoms (+16.6%), Utilities (+15.6%) and Consumer Staples (+5.6%), while laggards included Healthcare (-5.5%) and Financials (-5.1%) [all results include dividends].

Other markets that gained during the quarter were Brazil's Bovespa (+15.5%), Russia's Micex (+7%) and Mexico's PIC All-Share (+6.8%). Asian and European economies showing slowing or barely discernable growth were not so lucky, posting losses for the first quarter: Italy's FTSE MIB (-15.4%), China's Shanghai index (-15.1%), Japan's Nikkei (-12.1%) and Switzerland (-11.5%). The weakest

subsector of any market was the European banks, as represented by the DJStoxx 600 Banking index, which dropped more than 20% during the quarter, led by losses in Italian, German and Swiss banks. The European Central Bank's (ECB) decision to push short-term interest rates further into negative rates, plus weak economic situations in most developed European countries, led to profitability and credit loss concerns at the banks, driving down their stock prices.

In the words of 361 Capital's Blaine Rollins in his April 4th Weekly Roundup, "[i]t was a bruising 1Q for fund managers. In addition to famous hedge fund managers underperforming, more than 70% of large-cap core mutual funds have lagged the S&P 500 YTD, while 92% of growth funds and 75% of value funds have trailed their respective benchmarks." We see Kanos' outperformance this quarter as notable and believe that our understanding of recent market influences along with portfolio construction will continue to show good results in customer portfolios during 2016.

Precious Metals

The precious metals were the big winners for the first quarter, with gold having its best quarter in 30 years, rising 16.5% for the quarter and closing at $1,234.20/oz. In addition, many more investors were attracted to gold investments, as measured by the shares outstanding in the largest gold bullion exchange traded fund (ETF), SPDR Gold Shares, which recovered to levels not seen since 2013. Silver prices rose 12.0% during the quarter. Shares of gold mining stocks, as represented by MarketVectors Gold Miners ETF (GDX) rose 41.7% and Newmont Mining (the largest US-based gold mining company – which we own in some accounts) was the second largest gainer in the S&P 500 index for the quarter, rising 48%. The gains were due to rising uncertainty in the financial world, highlighted by faltering economic growth in the US and around the world and supported by the Fed's return to dovishness and further easing by the European, Japanese and Chinese central banks in response to weak domestic economies and dropping stock markets. The Bank of Japan's (BOJ) new policy of negative short-term interest rates, which joins the ECB's negative rates (for the Eurozone) as well as negative rates in Switzerland, Sweden, and Denmark, continued to build investor appetite for stores of value like gold and silver, which grow more and more competitive as interest rates are pushed to more negative levels – truly a surprising situation which very few people would have predicted just a few short years ago.

Energy

Energy showed extreme weakness early in the quarter, as winter was relatively mild in most of the industrial world, leading to less demand and growing stockpiles. However, the weakening of the US dollar starting in February and continuing into March took some pressure off oil prices, allowing them to rebound and leading to a big rally in energy company stock prices. In oil, WTI traded as low as $26.05/bbl on February 11th, but traded back above $42/bbl in March, ending at $38.34/bbl, up 3.5% for the quarter. The lack of demand that drove prices down near $26 affected natural gas, leading prices -16.2% for the quarter to end at $1.959/MMBtu, although natgas traded as low as $1.611/MMBtu in February. Both oil and natgas storage levels are at multi-decade highs due to lower

worldwide demand during this warm winter, leading many to forecast lower prices for longer until this excess energy in storage is used up. Energy stocks shrugged off the high storage levels and traded up by the end of March, best shown by the price action of the Energy Select SPDR ETF which rose 2.6% during the quarter after being almost -15% in January. However, just like in the general market, some subsectors in energy performed very different from the index: major oil companies like Exxon and Chevron gained 7-8% during the quarter, while the pipeline MLPs, as represented by the Alerian MLP ETF was -10.2% for the quarter, at one point being -35%! The "energy patch" still shows plenty of stress in spite of a large rebound of many energy companies in late February/March.

Bonds

High quality bonds did well during the quarter, most notably in January and early February when equity markets worldwide showed lots of weakness. Most bonds held their gains through the end of March as central banks worldwide reinforced their efforts for easier monetary policies and, in many cases, continued or even increased quantitative easing or bond buying (as announced by the ECB). US bonds performed the best, led by a rebound in US high yield and US investment grade corporates. Long-dated US Treasury bonds also performed well, with the 10-year Treasury yield falling from 2.273% at the end of last year to end march at 1.784%, its steepest quarterly decline in three years. This is in spite of a large amount of selling by the Chinese, estimated to have liquidated hundreds of billions of Treasuries during the quarter (although many were shorter-term Treasury bonds). We believe the performance of Treasuries in spite of large foreign sales shows that the safe haven aspect of holding Treasuries is still very much intact, and we continue to hold longer-dated Treasuries for their safety, yield and safe haven stability during stock market volatility.

Other Markets

Currencies were in focus as the US dollar weakened some from its strength during the second half of 2015. Most currencies had nice gains against the dollar, which led to stock rallies and increased purchasing power in most economies around the world, although, of course, it made foreign exports to the US less competitive. The euro ended up gaining 4.8% versus the dollar, while the yen gained 6.9%. The Mexican peso only gained 0.4% during the quarter, ending at 17.28 pesos/$ after falling as low as 19.44 pesos/$ in February (and only saved by Bank of Mexico's President Carstens announcing a surprise interest rate rise in mid-February that "stopped the bleeding"). We continue to think the US dollar will not show much more weakness as the economy here continues to show some growth and foreign central banks, most notably the Bank of Japan and the ECB, actively continue to pursue monetary policy actions that lead to lower and lower interest rates while trying to weaken their currencies in order to increase export competitiveness.

Going Forward

In surveying the investment landscape in April 2016, I keep thinking about a recent article title by investment advisor Lance Roberts in his weekly investment review and outlook titled: **Someone Is Going To Be Very Wrong**. I think that is where we stand in the investment markets right now: the re-emergence of corporate buybacks coupled with the rise of the crude oil price from its lows in mid-February appear to have taken the pressure off the financial markets. There seems to be a new narrative of "all the bad news is priced in" as nearly all equity markets have recovered their early 2016 losses; however, crummy economic data and continued falling US corporate earnings point to a less optimistic future for stock prices in both the US and other developed countries. We will be discussing "both sides of the coin" below.

Economy

April reports of economic statistics continue to show weakness in the US and overseas economies, although hiring statistics still show continued steady growth. While some of the nationwide economic surveys of manufacturing and non-manufacturing (service) businesses have shown some improvement, the majority have shown manufacturing continuing its recessionary contraction while service businesses appear to be growing modestly. April reports on retail sales fell 0.3%, with the "core" reading (less automobile and gasoline sales) rising only 0.1%, both far below expectations. Industrial production in April showed a drop of 0.6% month-over-month, the weakest in more than a year; with the 0.6% drop in production and the 0.3% drop in manufacturing both lower than the most pessimistic forecast. Finally, with a 74.8% reading, capacity utilization hit a low not seen since the 1970s. These statistics show the slowing of auto sales and production which is particularly concerning since autos have been touted as a big driver to the economic recovery. Monthly employment reports have continued to show growth in the 200,000+ range, but many of these jobs are minimum wage food service, retail and home health fields, cheapening their contribution to a growing economy.

We see few drivers for renewed economic growth due to high consumer debt levels, uncertainty over the elections and regulatory regimes, an obviously depressed energy industry (a big driver of economic growth 2010-2014) and a high US dollar (making US products less competitive worldwide). Generationally-low interest rates continue to allow less-competitive businesses to keep industries overly competitive and profitability low. In addition, recent drops in worker productivity have removed one facet of US competitiveness that has historically helped economic growth until recently.

Overseas economies continue to suffer from slowing growth. Japan's ongoing recessionary conditions could grow worse with the recent climb in the value of the yen, hurting their export competitiveness which they consider their main economic driver. Europe continues to see anemic growth, with most developed European countries growing at a 0.1-0.7% rate. Negative interest rates and increased quantitative easing in both regions does not seem to have had the effectiveness expected. We believe these economies could slide into recession later this year. China just

announced first quarter GDP at 6.7%, near the lower end of their expected range, although debt increased by another $1 trillion during the quarter, meaning this levered growth is unsustainable. We still see investors judging US growth (something under 1% for the first half of 2016) as more attractive, and we believe capital will flow toward the US, driving the dollar back up and pushing US export profits (and the price of oil) down.

Equities

US stock markets have an earnings problem: expectations for 1st quarter earnings are for -9.3% (in aggregate – lots of the drop is in energy and financials' results), which would also mark the fourth quarter in a row of falling earnings in the S&P 500. Revenues are also expected to fall again (-1.3% expected – both estimates from FactSet), which would mark the fifth consecutive quarter of lower revenues. These expected results (which are in line with what has been reported so far, even though less than 20% have reported through mid-April) push valuations up to new highs since 2000, above valuations at the 2007 peak and also above earnings of the S&P 500 peak last May. So stocks at this point are very expensive.

However (and doesn't there always seem to be a 'however'?), equity markets seem to be back to listening to the Fed for their direction – Janet Yellen has ignored the call for a follow-on to December's rate hike and continues to talk about threats to both the US and international economies, leaving US interest rates unchanged. As more and more people see the Fed as 'talking a good game' but not raising rates (in spite of continued gains in jobs monthly), more investors have raised their equity exposure, buying beat up materials companies, rebounding energy companies and low valuation financials, in spite of headwinds that point to continued poor earnings from those groups. And investors have said that 'lower for longer' interest rates and a dovish Fed justify higher valuations than in times past with far higher rates. In addition, a narrative has emerged that first half earnings are the bottom of this cycle, and there will be a return to earnings growth in the second half of 2016 and beyond.

We understand the argument for higher valuations and know that there are larger influences on stock valuations than earnings, but four quarters of falling earnings almost never happens outside of a recession and bear market. In addition, a large amount of buying power has been used to recover from the deep losses suffered during the first six weeks of the year – there is only so much 'money on the sidelines' to keep buying, and international buyers have not stepped up in any significant amount. In fact, as best we can tell, it appears that corporations buying their own stock have been a big part of the recent buying (Home Depot, GE, IBM, Cisco, Microsoft, Nike, according to 24/7 Wall Street) – the problem with this dynamic is that corporations will have to stop buying around the time of their earnings announcements during the next few weeks, taking away a key element of the past rally.

The power of a dovish Fed, coupled with a narrative of first half 'trough' earnings, has proven to be an ongoing force in the US and world stock markets, keeping markets from correcting appreciably. We do not plan to increase exposure without more evidence of fundamental improvement in global

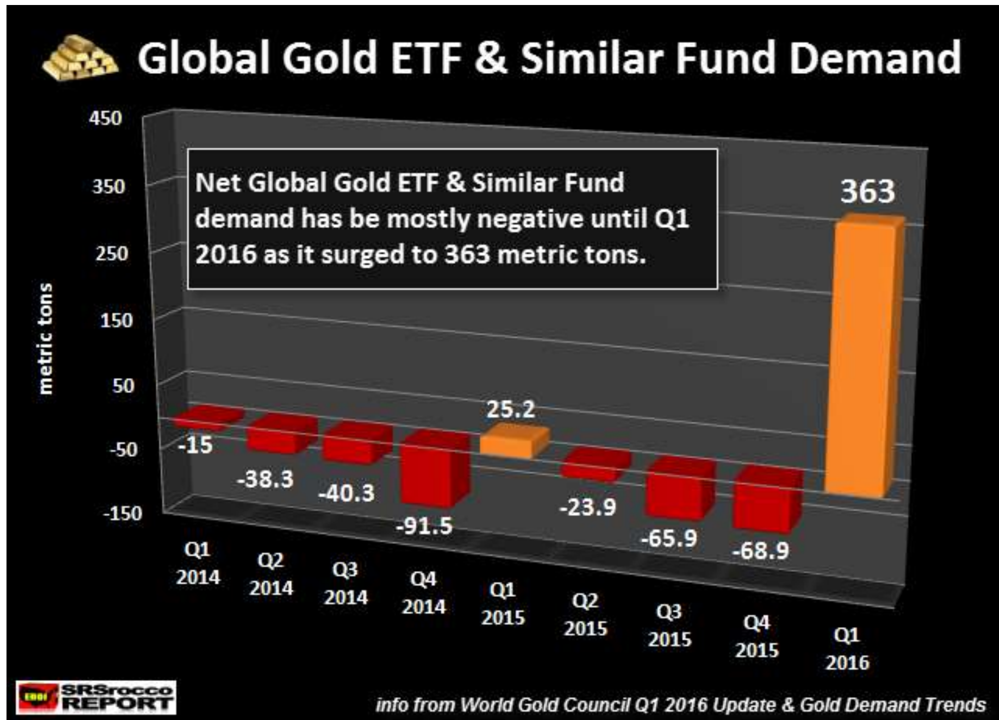
macro results or earnings growth visibility. However, we maintain a healthy exposure to equities through attractive stocks due to newly positive technical and momentum factors.

Precious Metals

With gold prices and gold miners' stock prices rising so rapidly during the first quarter, we would expect prices to consolidate somewhat as traders sell their winners and investors reallocate to better performing sectors like gold. The continued march of central bank easing worldwide, accompanied by a full-fledged currency war (in full force although not declared by any country other than Japan) however is pushing more people worldwide to reconsider past prejudices and buy gold as an investment and as a place to park cash, maintaining gold prices at newly higher levels and pushing up silver and metal mining stocks to new highs recently.

The BOJ's decrease in rates to negative in February, and the ECB's lowering of rates further into negative territory are strong drivers for moving capital into gold. Negative rates are bullish for gold because they: 1) lower the opportunity cost of holding gold – one knock on gold is that it doesn't yield and costs to store/insure, but negative rates give investors bonds that don't yield anything but cost the bondholder money, making it much more on par with gold, 2) erode confidence in the currency backing the bonds, meaning that one's capital denominated in that currency over time will drop versus stronger, more stable currencies, costing purchasing power and capital appreciation, and 3) limit the investors who will invest in an asset that is guaranteed to lose money if held to maturity – gold should prove to be a better store of value over time to institutions that traditionally put core assets into bonds.

Another element of what is helping improve gold's prospects are the amount of investors looking to invest in physical gold, best represented by the rise in gold holdings by gold ETFs. These funds buy physical gold (and silver) bars, and as the graph below shows, first quarter bullion ETF demand blasted upward during the first quarter, rising 363 metric tons – the second highest quarterly rise in the last 10+ years (second only to the first quarter 2009 at the equity market lows). As the graph below shows, 1Q buying overcame the drop in ETF holding for the last two years, indicating strong investor appetite.



The gold bear market that started in 2011 now is over, as gold prices have broken the price downtrend in place. As we compare this bear market to past recent bear markets, this one was worse than average (-44%) and about average in length (52 months) – see the table below. If history is any guide, the table below from Bloomberg and the World Gold Council shows that the bull market, if average, would push up prices almost 400% and last more than 40 months. Having studied and invested in the gold market for some time, we believe those numbers are probably low because of the monetary backdrop in which central banks have transformed the economic world. When inflation grows from its nearly 2% to a much higher amount, gold, silver and precious metals miners will rise even faster than they have in recent months.

Table 2: Gold has experienced five bear and bull cycles since the 1970s*

Bull market			Bear market		
Dates	M	Cumulative return	Dates	M	Cumulative return
1/70-1/75	61	451.4%	1/75-9/76	20	-46.4%
10/76-2/80	41	721.3%	2/80-3/85	61	-55.9%
3/85-12/87	33	75.8%	12/87-3/93	63	-34.7%
4/93-2/96	35	27.2%	2/96-9/99	43	-39.1%
10/99-9/11	144	649.6%	9/11-12/15	52	-44.1%
Average	**63**	**385.1%**	**Average†**	**47**	**-44.0%**
Median	**41**	**451.4%**	**Median†**	**52**	**-42.7%**

*We are defining a bull market as a period where US dollar gold prices rose for at least two consecutive years and bear markets as the subsequent periods where the price generally fell for a sustained time.

M=length in months.

†Excludes the period from September 2011 to December 2015.

Source: Bloomberg, ICE Benchmark Administration Ltd, World Gold Council

One last observation about precious metals bull markets: levered investments rise faster; thus, silver, which is much more volatile than gold, tends to outperform. Mining companies tend to outperform the metals themselves, and smaller mining companies, being much more thinly-capitalized, outperform larger mining companies. We have started to see two of these elements: mining companies have far outgained the metals during 2016, and silver has started to outperform gold. When we see junior mining companies start to outpace senior miners on a consistent basis after gold and silver hit new 2016 highs, that will mark the next 'up' phase in this bull market, and we intend to take full advantage of investing to benefit client portfolios.

According to The Gold Stock Analyst's April 1 issue, gold stocks are still 36% undervalued versus their recent historical valuations when compared to the recent gold price. We believe that as this gold bull market advances, that undervaluation will disappear.

Energy

Crude oil prices have been a bit of an enigma, echoing US equity movements mostly on the upside while facing fundamental headwinds, just like equities. The big boosts have come from rumblings about a summit to limit oil output – this rumor has driven prices higher three or more times, and the meeting happened in mid-April in Doha. As many expected, no agreement was reached, and the absence of the Iranians meant that any agreement would have excluded a major player's intent to increase production by up to 1 million barrels per day this year. This lack of a definitive agreement

only depressed prices temporarily, and oil is currently trading at multi-month highs around $44/bbl. We believe the fall in US production, coupled with much smaller production increases out of the Middle East (Iran, primarily), have combined with a lower US dollar and a dovish US Fed to keep oil prices higher than many (including us) expected. We are nervous about prices staying at these levels, especially because of the extremely high worldwide crude oil storage levels (see below) and the purported two million barrels per day of estimated daily production capacity that could come out of the Middle East.

Crude oil storage around the world is nearly full. This tends to contribute to capped prices as any demand growth in the short run can be fulfilled by drawing down from the record amount of storage. Thus, we continue to see crude oil prices as capped in the low $40s/bbl, and believe that any hawkish movements by the US Fed might actually push up the US dollar from its recent pullback, which would negatively impact crude oil prices, possibly driving them back toward the low $30s/bbl.

As interesting as the situation surrounding physical crude oil is the situation surrounding energy stocks. In spite of the "recovery" in oil prices back into the high-$30s/low-$40s per barrel, these prices are not high enough to sustain companies that invested large amounts of debt-financed capital at finding costs exceeding $80/bbl. Thus, those companies continue to declare bankruptcy, highlighted in April by Energy XXI and Goodrich Petroleum, two former high-fliers that are the latest of the 50+ oil and gas companies that have declared bankruptcy since the beginning of 2015 (according to law firm Haynes & Boone). These companies, after declaring bankruptcy, tend to try to maximize production to provide as much cash for recovery by bondholders, but keeping energy prices lower than if they were shut down. There have been over $14 billion in defaults in April 2016, the highest since 2014, according to the Fitch rating agency. The incentive for weaker players, especially bankrupt companies, to pump oil at maximum levels still strikes us as one main reason we don't see oil prices rising significantly for many months. Even large sovereign producers are not immune: Angola has asked the International Money Fund (IMF) for assistance but meanwhile is producing flat out to try to maximize cash flow. Saudi Arabia's money troubles are well-chronicled – they have been contemplating a large bond issuance and even a possible IPO of some of Saudi Aramco's (non-producing) assets to try to get sufficient cash to last until prices recover; but like other countries in similar straits, they are producing near their maximum of the past 20+ years.

In addition, with technological improvement and brutal cost-cutting, some production (including more recent shale drilling) is cash-profitable at these lower prices, and there is pressure on energy company managements to lock in prices at these levels by hedging with futures contracts. This selling, which seems to rise when deferred month futures prices reach near $50/bbl, in the past has exerted plenty of downward pressure on oil prices whenever oil rises to levels where hedging is ordered by lenders.

US natural gas is in similar straits to crude: supplies are high and demand was way off domestically due to a warm winter. Large discoveries in the Marcellus and Utica shales in Appalachia, coupled with technological innovation and relentless cost-cutting in exploration, have led to large finds of cheap natural gas near large demand areas in the northeastern US, pushing down prices of natgas across the nation. In addition, storage is concerningly full after a very mild US winter, and the lack of a place for flowing gas during the summer and fall (absent an early and very cold winter) could push

natgas prices to new lows below the $1.60s experienced during February. New petrochemical plants, built on the US Gulf Coast to take advantage of cheap natural gas, have added some new demand, but the gas dedicated to be liquefied (at the new LNG liquefaction plants being completed in Louisiana and Texas) are already confronting a worldwide glut of LNG that may cause more natgas to stay in the US, further depressing prices. As you can tell, we think natgas prices don't recover until either a cold winter helps drain the storage glut, economic growth causes more manufacturing demand (not expected for at least a year or more) or both.

We would like to expand our investments in master limited partnerships (MLPs) but want to see more clarification around producer bankruptcies. We were concerned that MLPs might have some of their revenue streams curtailed if their producer clients were to enter bankruptcy and appeal to the bankruptcy judge for a renegotiated (lower) rate to ship their energy on the pipeline. This actually occurred in the first quarter during the bankruptcy resolution of Sabine Oil & Gas, and we are concerned that this could affect MLP expected revenues and profitability. When we get more comfortable with the situation and effects on MLPs, we will look to increase our ownership of attractive companies in this sector.

Currently, we own integrated and large independent energy companies that we can analyze more traditionally. We are much more wary of "short-cycle production" companies drilling in shale that we find harder to analyze and could find themselves permanently "wounded" and beyond help if prices don't recover significantly within 1-2 years.

Bonds

Treasury bonds have been in a trading range since hitting highs (low yields) on February 11th when equity markets hit their 2016 lows. The influence of lower yields overseas continues to supply buying interest in US Treasuries, while liquidation of international assets to pay for budget deficits and dollar-denominated indebtedness keeps bond rates from falling to new lows. Shorter-term Treasuries have followed the perception of the Fed's proclivity to raise rates – falling during January as equity markets showed weakness, rising from mid-February when equities recovered and Fed governors hinted at a rate hike in March/April, then falling from mid-March onward as Chair Yellen's dovishness won the day in FOMC discussions. We see more of the same happening, although we believe longer-term Treasuries will hit new highs (lower rates) as equity markets flatten out or weaken and Fed spokespeople try to talk up a rally in stocks by proposing more 'lower rates for longer' sentiment at the Fed. This has been partially offset by a budding narrative of "emerging inflation" which many people see as limiting new lows in bond yields. More time will be needed to see whether these levels of inflation impact bond yields significantly in 2016.

International bonds seem extremely overvalued to us, although they are held at these levels by central bank actions. Japanese 10-year government bonds (JGBs) have hit new low rates in mid-April at -0.14% - yes, a negative rate for 10-year bonds, and we believe Abenomics in Japan will continue to support the Bank of Japan buying bonds at negative yields in order to continue to supply stimulus to Japan's weak economy. Germany's 10-year Bunds are also trading at microscopic yields; in mid-

April they are barely positive at +0.17%. The sputtering European economies need very low interest rates to compete, and we believe Mario Draghi and the ECB have more support across Europe to continue their negative interest rate policy and bond-buying to keep rates extremely low, especially if European economies slide into recession.

We have been surprised by the strength in high-yield debt in the US – continued low oil and natural gas prices have forced more and more exploration and production companies into bankruptcy, and the rest of the US corporate sector is reporting a fourth consecutive quarter of falling earnings, meaning delinquencies and defaults should continue to rise; however, in spite of these statistics, high-yield bond ETFs have risen more than 10% from their February 11th bottoms, as more investors chase yield due to an increased hope of a second half of 2016 earnings growth revival that helps the future prospects for high yield bonds. We don't believe in a sudden recovery in the latter half of 2016 (and are more on the lookout for a 2016/2017 recession), so we believe this rally in high yield is ill-fated and doomed to failure as more and more weak companies fail to pay bondholders during 2016.

Other Markets

With both the Bank of Japan and European Central Bank trying to keep their currencies as low as possible to help make their all-important export industries more competitive to hopefully boost their economies, the yen and the euro are vulnerable to moves downward. In recent months, both have gained against the US dollar as policy changes by both banks were considered too weak and the "short yen" and "short euro" trades became too crowded. But as each of these two currencies seem to have stalled in recent retracements, we believe there is a good chance that the banks' efforts and the end of short-covering will allow both the yen and euro to drop in value versus the dollar, making the "short yen" and "short euro" trades attractive going forward.

The strength of the Canadian, Australian and New Zealand dollars is more puzzling to us – these currencies are rallying against the US dollar although their economies are not out-growing the US economy and commodity prices, especially oil but also base minerals (copper, iron ore, tin, etc.), have only slightly recovered from multi-year lows. We believe these currencies have rallied because of the relatively high yields and the thought that the central banks of these countries are more hawkish than those in the rest of the developed world, meaning interest rates will stay higher. We believe their rates are only temporarily high, as the effects of low oil and minerals prices will eventually slow their economies to the point where all three central banks will be forced to lower interest rates in line with other developed world interest rates, causing capital to move out of these currencies and sending them back toward recent lows.

Future Considerations

We strive to make investments based on medium or long-term themes that we believe will lead to increases in wealth for our customers. In this letter, we would like to more formally present some of these themes so you can see where our strategy and our investments could benefit your portfolio.

We see a number of these themes as slowly developing but inevitable, so we believe that they are investible now and in the future. We will size investments appropriately as each theme develops.

Low Interest Rates

The Great Financial Crisis of 2008-2009 caused central banks to lower interest rates to generational lows. Since then, the lack of any robust economic recoveries in developed world economies has caused central banks to lower short-term interest rates even further and institute buying of longer-term bonds (quantitative easing) to further lower interest rates across the yield curve. In the past year, the European Central Bank and Bank of Japan have further lowered short rates so that they are now negative! (yes, you get back less money than you initially invested)

Theme: We believe central banks continue to believe in their theory that weak economies will respond to stimulus (even if it is eventually); if they don't respond initially, you just need to apply "moar" stimulus until the economy responds. Thus, even though we believe low rates may be hindering economic growth by allowing capital to flow to suboptimal investment opportunities and allowing debtors to take on so much debt that servicing costs eventually choke off further productive investment, we think central banks will continue to promote low (or negative) interest rates to keep carrying costs down and debt financing available. Thus, finding investments that yield attractive amounts, while adjusting opportunities for risk, will be one major key to successful investing for the next few months and possibly for years.

Investment: We own long-term US Treasury bonds and other beneficiaries of lower interest rates (while paying attention to credit concerns) such as utilities, mortgage bond REITs and large-cap consumer staples companies with attractive dividends. We will look to investigate REITs and MLPs as conditions and credit concerns dictate.

Risk: Credit concerns by potential lenders in the capital markets and rising inflation both threaten central banks' ability to keep rates low and debt growing. We believe at some point central banks will have a problem keeping rates low but not in the near future. Having positions that pay you in a risk-adjusted manner during this yield-starved period is very important. We also believe these positions will act as cushions as over-valued equity markets correct due to high valuations and falling growth

and earnings prospects. Once equity markets have corrected and bond markets re-adjust to new valuations and new economic/growth paradigms, we believe it will be time to lighten up on this theme.

Inflation

The natural consequence of monetary stimulus and debt creation is typically inflation. Inflation is defined in many ways, but we will be referring to inflation caused by too much money and debt chasing too few goods. A good illustration of recent inflation is seen in the fine art world; new highs in the price of paintings, especially in modern art, shows the influx of large amounts of money into a market with limited demand (from deceased artists like Mark Rothko). In the financial world, many equate economic inflation with wage inflation, in which workers demand higher wages as costs of living increase. We believe wage inflation has not increased due to the slow absorption of worldwide labor into world economies, which has resulted in workers having less of a voice in demanding higher wages due to the ability for jobs to migrate to lower wage economies overseas. However, we believe central banks' monetary stimulus over the last few years has led to inflation, and their inaction toward fighting inflation currently will lead to increasing inflation in the future.

Theme: We believe central banks' monetary stimulus has caused more inflation than is generally measured. In addition, central banks seem to believe that economies can only grow if prices increase over time, so they have almost universally adopted a 2% annual inflation target that they believe will help foster economic growth. We believe the extreme monetary stimulus starting in 2009 in the US and China and added to by numerous stimulus programs in Japan and Europe over the past several years, have added an unprecedentedly high amount of available funding that will continue to push prices up in virtually all consumer and business costs. Commodities, currently in oversupply, will not show extreme inflationary effects initially. But low interest rates, high international demand, and low inventory of homes and apartments have caused "shelter" costs to increase 3.2% year-over-year (with the subset of rent increasing 3.7% y-o-y). In addition, Obamacare has caused medical costs to increase 3.6% y-o-y. With only energy costs falling, March consumer prices were up 0.9% y-o-y, but core inflation (minus "volatile" food and energy costs) was up 2.2% y-o-y. With Fed Chair Yellen worried more about the level of the US dollar and its effect on world economies than US prices rising, we believe current policies point to more inflation. The abovementioned concern about any rise in interest costs choking economic growth should also lead to the Fed waiting until inflation really rises before addressing it.

Investment: We believe traditional investments in commodities, real estate, asset-oriented stocks and currencies are investments that will benefit as inflation pressures grow. Obviously, commodities perceived to be in current surplus (oil, natural gas, coal, copper, iron ore, etc.) will not show the benefits as readily as investments like precious metals, which grow only small amounts per year. Thus, we will maintain precious metals and mining investments, increasing them when we discern attractive fundamentals and price action. Real estate, in vehicles with attractive valuations, will be pursued, especially where yields can be increased as inflation grows. And many stocks, especially agricultural and base metals companies, should benefit from rising selling prices, as will companies

able to pass through price increases such as food companies and supermarkets (and other distribution companies of essential goods, like consumer staple stocks). Finally, commodity currencies will benefit, while currencies of consuming countries will fall in high inflation periods, so investing in commodity currencies while short consuming countries could be good long-term investments.

Risk: The risks around inflation-themed investments are the same faced during 2011-2015: if the market perceives little inflation or little reason to defend one's portfolio against inflation, these investments can fall to very low valuations as investors pursue growth companies and eschew value. In addition, government interference in pricing and cost can distort investments in government-targeted industries (e.g. Kennedy's "war" on the steel industry in the 1960s, Nixon's wage and price controls in the 1970s). And obviously, if the Fed starts to perceive inflation is growing too fast, it can start to raise interest rates to try to control prices.

Euro Weakening

The euro is a political construct that has no sovereign government or army backing it, although the European Union has a government that governs its members on a collaborative basis with each country's government. We believe the changing economic conditions and each country's differing methods for dealing with them threaten the "half integration" that the Europeans have done. Thus, we believe the euro is eventually doomed unless the EU can integrate politically, which we think will be almost impossible to accomplish at this point.

Theme: Weakening the euro has been the major "tool" which Mario Draghi and the ECB have used to try to restore growth in European economies. So far, a weaker euro has helped keep European countries out of recession, but in spite of Draghi's increase in monetary policy measures this spring (which has a partial goal of a weaker euro), it has been slow to weaken further. We believe that in spite of criticism from the Germans, the ECB will continue to try to depreciate the euro (at least versus the US dollar) in order to improve export price competitiveness. We also think that if European economies don't improve in the next couple of years, you could have cracks in the "European experiment" in general, punctuated by countries leaving and changing the prospects of the euro permanently. In addition, the "wildcard" of the Middle Eastern immigrant problem has contributed to making any further integration impossible and led to rising popularity of nationalist groups and their fractiousness.

Investment: We will invest in ETFs that allow us to be short the euro versus the US dollar. Depending on how well the ECB succeeds at lowering the currency, we could invest in funds that own European stocks with the euro hedged out of the performance, allowing us to participate in rising European stock prices without losing money on the weakening euro.

Risk: The major risk is that countries start leaving the euro and leave the Germans dominant in the euro, turning the relatively weak euro into a much stronger deutschmark surrogate. While a significant risk, we see the EU as having a hard time staying together because of the widespread distrust of Germany (because of the German tendency for dominance) and the difference in the

situation among the poorer countries, like France which is currently very weak economically. Thus, we could also see a stronger Germany leaving the euro and re-establishing the Deutschmark, leaving the euro in a much weaker state. These two diverse outcomes will obviously impact how we continue to implement this strategy.

Yen Weakening

Japan has been in various stages of economic distress since 1989 when its huge stock bull market peaked. Japanese political, economic and monetary authorities have tried a number of different strategies to try to get Japan's economy vibrant and growing again, but they have not been able to find a strategy to lead to sustainable growth. However, since Japan's economy since World War II has been export-based, they continue to try to gain competitiveness through a weaker yen, which allows Japanese manufactured goods to be more competitive in international marketplaces (although it makes imported raw materials more expensive at the same time).

Theme: Weakening the yen has been a major plank to Abenomics, and we believe it is one of the easier policies to pursue politically. Thus, in spite of the recent consolidation and strengthening of the yen/US dollar exchange rate, we expect Japan to renew its efforts to further weaken the yen. The Japanese have embraced robots and productivity improvements in their factories in order to lower production costs and offset high import prices for raw materials.

Investment: We will invest in ETFs that allow us to be short the Japanese yen versus the US dollar. Depending on how well the Japanese succeed at lowering the yen, we could invest in funds that own Japanese stocks with the yen hedged out, allowing us to participate in rising Japanese stock prices without losing money on the yen weakening.

Risk: The risk is that if the yen depreciates versus the US dollar, the strong dollar will cause some of the economic turmoil we saw earlier in 2016, namely, lower oil prices, higher stress on foreign countries who have borrowed (and must pay back debt) in dollars, which could lead to selling of foreign assets of sovereign wealth funds and overseas investors like the Japanese. In past periods of market turmoil, we have seen the yen strengthen due to: 1) repatriation of Japanese investments from weaker overseas markets (paying back of the "yen carry trade") where investments financed in borrowed yen are paid back after the investment is sold, and 2) money moving to a more stable currency and political regime, of which Japan is considered one of the most stable. Thus, these are short-term threats to profitability of this opportunity, but we generally see them as short-term.

Extremely High Levels of Debt

While many of the abovementioned themes entail high debt levels, we believe it is worth briefly talking about debt levels as a theme that affects our investment decisions. Debt is generally a conventional way of financing an asset or project that has a stable valuation or steady cash flows and allows financial institutions to comfortably calculate a valuation estimate in order to lend money to

the borrower. Financing has a set cost (although the cost might be a formulaic [floating] cost of interest) that borrowers are obligated to pay back before other stakeholders receive proceeds. However, through central bank monetary policy and governments' fiscal and tax policy, debt has been transformed into money creation and a virtually unlimited financing source for developed market governments and multinational companies.

Theme: The unbelievable proliferation of debt has changed the financial landscape, making central banks and world governments (huge debtors themselves) skew policies and actions toward debtors; thus, we see lower interest rates as de facto policy. In addition, the huge amount of debt per capita now outstanding has started to hamstring borrowers, making them start to repay debt as the ability to pay interest on high levels of debt has impacted behavior. Also, corporations have borrowed large amounts of debt to finance share buybacks, so analysis of investment opportunities must include each company's debt situation because many companies potentially have too much debt to qualify as good investments (e.g. IBM).

Investment: As mentioned above, company debt levels, most recently due to share buybacks, impact our investment criteria as debt levels and interest costs raise risk around investments. In addition, companies with high yield bonds outstanding have seen the mechanics of their financial markets (gating of mutual funds, eliminated bank bond inventories due to the Dodd-Frank Act, etc.), along with their underlying business fundamentals, impact our decisions around owning them. Finally, high sovereign debt levels also impact countries' fiscal policies and often impact investors' perceptions about countries' currencies. Thus, understanding debt levels and the limits they impose on countries affects our investment decisions (e.g. China) and could lead to currency movements [hedge fund investors George Soros and Kyle Bass are currently betting on China's devaluation of the yuan, partially due to China's extremely high sovereign (and banking system) debt levels]. We will be less inclined to invest in companies with higher debt levels than they have carried traditionally. In addition, we may invest in bonds of less levered companies whose bonds we believe are undervalued due to concern about the industry segment at large.

Risk: The risk around changing our investment choices due to high debt levels is mostly if the investment world does not perceive the amount of debt to be a problem. If debt levels are ignored by investors, debt may trade more normally and currencies could adjust due to more normal economic changes, rather than due to debt levels driving decisions.

One last comment: all the investment themes above incorporate a reaction to central bank actions. While we would like to invest without an eye on what central banks are doing, in this day and age, central banks have hijacked markets (or at least exerted a historically large amount of influence on them), meaning that incorporating central banks thoughts, policies and actions into one's investment formulation and evaluation is essential.

These are a number of major themes that we use to construct customer portfolios and examine the investment landscape to find new attractive investments. While we look at countries and sectors from

the top down, we also tend to try to find attractive companies that we believe aren't negatively affected by the abovementioned themes but could be uncorrelated with current investments, leading to better overall investment results and diversification. We are constantly striving to examine our investment biases and methodologies to find new and diverse investments that conform to our investment framework and are attractive from a valuation, fundamental and technical perspective.

The Managers of Kanos Capital Management
© 2016 by Kanos Capital Management, LLC All rights reserved.