

Second Quarter 2017 Investor Letter

Portfolio Comments

Our portfolios performed in line with US markets but sold off in June, cutting earlier gains. Many aspects of the financial markets have been counterintuitive during the first half of 2017. The biggest surprise has been the relative weakness in the US dollar (mostly vs. a strong euro), caused by shifting opinions about the strength of European economies versus the US economy. This has meant our portfolios acted unevenly as many of our positions worked well and other suffered. Our strong dollar thesis only partially worked (against the Japanese yen) but our euro short was a loser (and we exited the positions). Our US multinational companies performed well with a weaker dollar, as did our precious metals, but a deflationary scare during June knocked them down. Our technology positions gained during much of the quarter but were hurt by a late June sell-off, limiting gains for the second quarter. All-in-all, financial markets reacted poorly to mixed messages by world central banks, as the European Central Bank (ECB) and US Federal Reserve (Fed) took a more hawkish stance while many economic statistics showed growing economic weakness. As of July, our portfolios have bounced back from June losses, and we have shifted more of the portfolios into income-producing positions because we feel the Fed confused the market and will revert to its all-too-familiar easier monetary stance, which will favor investments that benefit from lower rates.

Our portfolios' performance versus the indices is not dissimilar to many other investors' experiences as the gains shown by the indices were driven by a relatively small number of stocks that rose strongly during the first half of 2017, mostly due to inflows from passive investors rather than impressive earnings or corporate developments. Many of these stocks are "highfliers" that trade at huge valuations which we believe are not worth the risk due to very high expectations surrounding their future results. These stocks are the ones that lose a lot of value when the optimism fails (for example, Valeant Pharmaceuticals fell from its peak near \$260 in April 2015 to a low of \$8.31 in May 2017 when they started to miss operationally). In the first half of 2017, some of the winners that pulled up the index included: Vertex Pharma +75% (biotech, 228x P/E ratio, revenue growth of 80%), Activision Blizzard +59% (video games, 46x P/E ratio, rev. growth of 18.6%) and Align Technology +56% (dental technology, 59x P/E, rev. growth of 30%). Also driving the advance were "stratospherically" valued FANG-T stocks: Facebook +31% (42x P/E, rev. growth of 49% but already the fifth largest company on earth reaching more than 2 billion users in 2017), Amazon +29% (198x P/E, rev. growth of 22.6%), Netflix +16% (245x P/E [but negative cash flow], rev. growth of 32.3%), Alphabet/Google +17% (32.6x P/E, rev. growth of 22.2%) and Tesla +61% (no P/E because no profits, rev. growth 135% on a very small # of cars). As these examples show, these companies are extremely highly valued and subject to "Valeant" types of falls if they miss earnings or revenue estimates. A number of our portfolios do own some higher valued stocks that performed well, but

ownership percentage in the portfolio is smaller than their market-cap weightings in the indices: Apple +24% (18x P/E, rev. growth of 4.6%, 1.66% dividends), Microsoft +11% (32x P/E, rev. growth of 13.1%, 2.1% dividends) and Philip Morris Int'l +28 (26x P/E, rev. growth of 4%, 3.5% dividends). We avoided the disaster stocks in energy and retail stores on purpose; many stocks from those two groups had 30%+ losses during 1H 2017.

Finally, some of our natural resource stocks that got caught in a “deflation scare” in June brought down our improving performance in April and May; many of these positions are near their May highs as this temporary swoon in June gave way to the market recognizing their improved fundamentals.

Second Quarter Market Conditions

April was a rollercoaster month, changed in many ways by the results of the French election, which reassured investors worldwide and allowed riskier positions to be added back to portfolios. In addition, earnings growth for US stocks helped investors take on larger amounts of stock market risk. The S&P 500 gained 0.91% for the month (1.03% with dividends included) and was led by stocks in the Technology, Consumer Discretionary and Industrial sectors. Laggards included the Telecom, Energy and Financial sectors, which were all lower for the quarter. Due mostly to optimism after the French election, the Stoxx Europe 600 ended up 1.6% higher for April, reversing an earlier month loss. West Texas Intermediate (WTI) crude oil initially gained during the month, but ended dropping under \$50/barrel (bbl) as production again seemed to exceed demand gains. Gold was higher, but silver was the big loser for the month. US bonds were higher for the month as inflation fears moderated and the economy barely grew (as shown by an estimated +0.7% GDP gain in the first quarter)

May was a steadier month, with mostly steady gains in world stock markets. The two biggest events of the month were a sudden sharp drop in stock prices on May 17th when markets got nervous about President Trump’s possible meddling with the FBI probe into Russian attempts to influence the 2016 US elections. As facts that refuted trouble for Trump surfaced, stock markets resumed their rise, buoyed by the Fed meeting minutes released in late May that indicated the Fed would be moving rates higher more slowly than markets had priced. The S&P 500 ended up +1.33% for May, led by more gains in the Technology sector, and helped by gains in Utilities and Consumer Staples sectors. The Financial and Energy sectors were losers for the month. Oil continued its weakness during the month, with WTI closing below \$50/bbl again (after regaining that price level during the middle of the month) as oil market participants’ skepticism that the 2017 production ceiling would continue without much quota cheating weighed on prices. Gold and silver were both higher for the month as were mining shares. Treasuries were initially lower during May, but as more economic statistics came in under expectations and the Fed signaled a more dovish path toward higher rates, long-term rates fell (as bond prices rose), ending at 2.198%, firmly below the trading range for the past few months.

In June, most assets continued their May climb in the first half, but gave back the gains (and part of May’s gains) in the second half of the month, caused in part by the Fed announcing a more hawkish stance at their June meeting. The S&P 500 had a total return of 0.62%, but sector performances were

very diverse. Financials and Healthcare were the winners for the month, although Materials, Industrial and Real Estate were also higher. Consumer Staples, Utilities and Telecoms were lower, and surprisingly, Technology was also lower for the month as large tech stocks gave up their recent gains. Most foreign stock markets were around unchanged for June, and bonds were also mostly unchanged, domestically and internationally. Commodities were lower for the month as fears of deflationary forces re-emerged, triggered by lower oil prices and reinforced by European Central Bank hawkish policy rhetoric. Wheat was the exception, rising more than 18% on recent supply/demand concerns due to hot dry weather in the US Midwest.

Equities

US stock averages rose during the quarter but decelerated from the first quarter's pace; the Standard and Poor's 500 rose 3.09% (total return including dividends), and was up +9.34% (total return) year-to-date. The majority of these gains are attributable to the easy monetary policies in the first quarter, which were curtailed in June when many market segments gave back earlier gains. Through May, world central banks created an additional \$1.5 trillion of quantitative easing (without the US Fed participating), causing world markets to soar as investors sold US dollar investments and embraced more risk. To wit, Greece (+19.2%), Turkey (+12.4%), Argentina (+12.4%) and South Korea (+11.8%) [a developed world market but in the shadow of North Korea's nukes] were big winners during the quarter. The biggest losers during the quarter were energy stocks, which suffered from dropping crude oil prices (which fell from \$54/bbl in April to a low near \$42/bbl in late June). For the year to date, winners in world stock markets were Hong Kong, South Korea (along with falling Korean won), India and the US Technology sector. Losers for the first half were US Telecom and Energy stocks.

The pivotal move of the quarter, as mentioned above, was the blunting of the US market's advance by the Fed after its rhetoric was much more hawkish during its June meeting where it signaled at least one more rate hike in 2017 (it is the only major central bank hiking) and actually verbalized a tentative outline of balance sheet reduction (or selling Treasury bonds, the equivalent of raising longer-term interest rates). These moves spooked the US markets, most notably the high-flying mega-cap "FANG-T" stocks (Facebook, Amazon, Netflix, Google [now called Alphabet] and Tesla), but also pulled down safer, higher-yielding stocks like consumer staples, utilities, REITs and high yield bonds as rate hikes and balance sheet reductions were projected to raise short- and long-term rates, making those stocks' yields less attractive.

Energy

Energy prices were a key driver of events during the second quarter. WTI prices were the bellwether, peaking in April above \$52/bbl before falling 9% for the quarter after a 21.9% fall during June, closing at \$46.04. Weakness was caused by increased production from OPEC members without quotas (Nigeria and Libya), stubbornly high US inventories (that didn't drop as much as expected as summer driving/holiday season cranked up), still-rising US shale production (nearing its 2014-2015 highs when prices were much higher) and weak economic statistics in the US and Japan (European and Chinese data were only slightly better, pointing to weaker future demand).

Energy stocks, while seeing rallies during the quarter, ended the quarter lower (despite an end-of-June rally) as more worldwide production caused lower realized prices, limiting profits. The major oil companies held up much better than independents, and the European majors performed best. The S&P Energy Sector SPDR closed down 13.8% for the quarter.

Bonds

US bonds were range-bound and much more stable than in recent quarters. The US 10-year Treasury varied between 2.14% and 2.42%, with much of the time spent in the 2.20s, closing at 2.298%, as bond traders weighed higher yields versus worsening economic statistics and moderating inflation. The hawkish talk of European and British central bankers was offset by their continuing bond purchases, muffling European bond moves, although late June statements by ECB head Draghi sent German 10-year government bond (“Bund”) yields to 2017 highs at 0.47% (from a low of 0.18 in April). Japanese 10-year bonds rose over the Bank of Japan’s 0.00% rate cap, causing Japanese intervention, which kept Japanese Government Bonds (JGBs) yields capped but led to downward pressure on the yen. Overall, bonds were much more “well behaved” than in recent quarters.

Precious Metals

Precious metals were lower for the quarter after hawkishness emerged from central banks in June. Gold closed the second quarter 1% lower at 1,240.70/oz while silver was more than 10% lower. However, both are still higher for 2017, with gold up more than 7.9% and silver up 4%. Mining companies, pressured by higher local costs in emerging market mines, were lower for the second quarter, as results were judged disappointing due to few revenue “beats.” Many of the stocks revisited their December 2016 lows in spite of higher 2017 gold and silver prices as investors were spooked by central bankers “tough talk” and fear of a higher US dollar.

There was one more market distortion that hurt the performance of gold stocks during the quarter. The ETF which owns “junior” (smaller) gold miners, the Van Eck Vectors Junior Gold Miners ETF [GDXJ], started experiencing the need to buy/sell larger volumes of the underlying (small) than it could accommodate. Fund managers decided to substitute larger mining companies (and even the shares of the GDX ETF, which holds only large miners) for a time. Realizing the GDXJ ETF no longer conformed to its constituent index, fund managers changed the eligible stocks for the fund, which caused some of the smaller stocks in the ETF and the GDX shares to be divested by June 19th, causing waves of front-running selling by traders and pushing down prices and market caps of the GDXJ and GDX ETFs and a number of the junior gold miners. Those positions bought to replace the juniors weren’t bought in enough quantity to boost their prices until the bulk of selling had already depressed prices across the sector.

Other Markets

The US dollar was the surprise of the quarter, falling 5% from its April highs (more than 6% lower than its March 2017 high) as European political problems melted away with the elections of President

Macron in France, the expected re-election of Merkel in Germany and resounding wins by their parties in local / lower house elections. These “more-settled” political situations led investors to move more risk money to European investments, pushing up the euro (and Swiss Franc) against the dollar consistently all quarter long. Hawkish comments by ECB head Draghi also led to a jump in the euro late in June, in spite of some hawkish comments earlier in June by Fed Chair Yellen and the FOMC after their June meeting. The Bank of Japan (BOJ) kept up its quantitative easing, especially as yields moved up to its self-proclaimed 0% limit, helping keep the yen weak during the quarter.

The most exciting market action during the quarter besides the energy sector was in cryptocurrencies. The oldest, Bitcoin, rose over 100% during the quarter on increased Japanese and South Korean buying (both countries approved the use of cryptocurrencies and both are directly threatened by North Korean nukes), Chinese buying (circumventing state currency controls on the yuan) and speculation of higher prices in the rest of the world. According to the Wall Street Journal, Bitcoin started the quarter at \$1,079.75/bitcoin and ended at \$2,557.39, reaching a high of \$3,019/bitcoin on June 11. Ethereum, or Ether, the second-largest cryptocurrency, was up nearly 50x to as high as \$395/Ether before falling back to \$304/Ether on June 30. These cryptocurrencies have gone “parabolic”, exhibiting “bubbly” price action by rising 200-5000% in a matter of months. This behavior shows extreme speculation, caused by wildly easy money worldwide and behavior that is usually seen before popping bubbles cause financial upset, often in more financial markets than just those where the speculation was most intense.

Going Forward

Economy

The economy continues to bob and weave, showing some strength and at other times showing weakness, confounding economists, analysts and investors alike. Employment statistics are the most watched economic numbers, and they have lurched along, varying generally between 140,000 and 230,000 job additions per month, roughly the rate needed to absorb new workers and keep the unemployment rate constant, which currently stands at an impressive stated-rate of 4.4%. At the same time, we have more than 93 million Americans of working age not counted in the labor force, which means they are not productive and must be provided for either privately or publicly, robbing the economy of some of its productiveness. This could change for the better if the Fed raises interest rates and the economy responds (or at least companies respond) [see our commentary at the end of this letter “Ben Hunt is Right”] However, with retail sales either staying flat or falling slightly (as has happened many months this year), the consumer economy seems to be stuck in neutral.

If we were to see any fiscal progress out of Washington – tax cuts, health care overhaul, a plan for replacing aging infrastructure – we believe we would see some upticks in the economy. However, with the Fed raising rates (which raises the financing costs on all kinds of adjustable rate consumer

debt and mortgages), we see the economy having a harder and harder time improving. More likely, it is slowing and will continue the current malaise until the Fed either 1) raises rates high enough to cause a recession or 2) stops raising (and reverses course to start lowering interest rates again) to reignite the flagging US economy.

Equities

Despite our pessimism about economic growth, still-low interest rates combined with domestic and international fund flows indicate to us continued future rises in stock prices into the third quarter. When looking through the lens of technical analysis, trends point to higher stock prices, as small, large and international stocks continue to approach or reach new highs.

April through October is usually the time frame when the stock market underperforms. So far in 2017, the markets have confounded the historical trends, climbing roughly 1% in both April and May and eking out a small gain in June. After encountering a sell-off in June, most market leading stocks have consolidated their positions, and have either approached or reached new highs during July. In spite of sky-high valuations in many cases, stocks seemed poised to move higher. For the past few months, technical analysis has shown few concerns about longer-term indicators, so we see the market continuing its rise.

The real concern of many market pros is the longevity of the recent rally and its lack of meaningful corrections that are usually considered healthy retrenchments bull markets need to restore balance and entice future buyers. With investor sentiment skewed toward the high end of bullishness, we and other professionals worry about the possibility of a dislocation in the markets. In 1987, the stock market climbed most of the year, topping in mid-August, correcting some during September and October, and then crashed 22% on October 19th when bad news hit a vulnerable market. This market in many ways is similar in that it has a large component of non-stock-specific market players; the high percentage of index investors leads to investing in companies due to their size or classification instead of based on their forecast future cash flows. If certain large stocks report bad news and cause the major market indices to head downward, we could see gathering downward momentum. Stock market crashes are rare events, but they are always preceded by a time when sentiment is very one-sided, unfortunately like we see today.

Precious Metals

The precious metals complex sold off in June, but June is traditionally a weak month for gold. July, August and September are typically strong months for precious metals prices, as late summer/fall harvests combine with Diwali, Christmas and New Years as reasons for consumers worldwide to buy gold. There is a lot of promise for the future of the gold complex as detailed further below; thus, we are maintaining our positions.

What is so promising? It starts with demand – according to the World Gold Council, Indian demand, which had been weak last year, is showing much more strength in 2017. The monsoon rains have produced bumper crops in India this year (enriching farmers), and Indians have returned to the gold

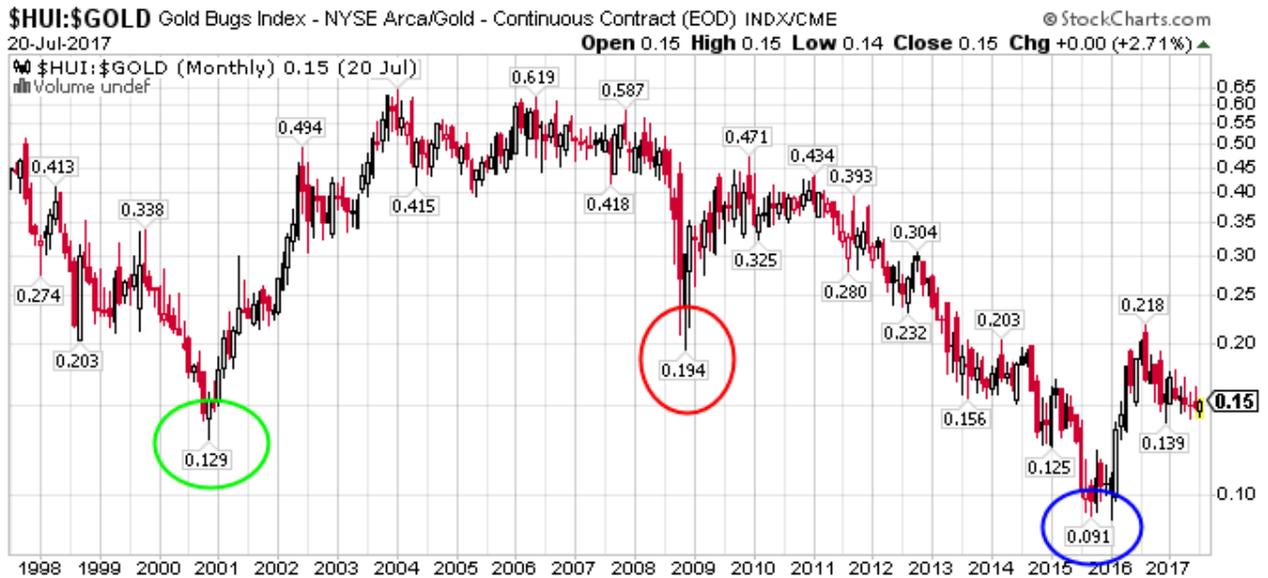
markets in force: May's demand was up 237% y-o-y, and year-to-date, demand is 459 tons compared to 584 tons for all of last year. India, the world's largest gold buyer, is always important in helping determine gold price dynamics. Supply has also moved into a favorable position – mine supply has actually started to fall year-over-year (-0.4% in the first quarter 2017, according to London-based Metals Focus), and years of lower gold prices have forced mining companies to sharply reduce exploration budgets in recent years, hurting production growth. Thus, both demand and supply are supportive of higher prices.

Second, speculation in the gold markets has reached such a bearish crescendo that the risk-reward is highly skewed toward higher prices. According to Bloomberg, “managed money gold futures and options” short positions have reached an 18-month high (second only to gold's multi-year low reached in December 2015), which means traders inclined to short gold have probably done so. After the December 2015 low, gold prices climbed 30+% and gold mining shares were up almost 100% in six months with a similar one-sided set-up as we see now.

Third, and possibly most important, the Fed has started changing policy: raising rates, threatening to shrink its balance sheet (which will “feel” like higher rates as liquidity is removed from the financial system) and talking tough. This change is actually introducing more risk into financial markets, which will start to move traders and investors away from highly-valued blue-chips and technology stocks at the margin, and into lower-valuation, beaten-up, less risky value stocks like miners. Rising gold prices will also add to their allure.

Mining companies have been through the ringer – managements have all been changed, with costs reduced to the bone and exploration minimized as businesses fought bloated bureaucracies and high debt taken on when resource growth was the mantra. Now, these businesses are run efficiently, watching costs and capital allocation so that as gold prices rise, much of the higher prices will fall to the bottom line as increased profitability.

Investors haven't recognized the improvement in industry efficiency, as shown in the table below. Fred Hickey, in his June High Tech Strategist newsletter, describes why he likes a number of gold mining investments over technology holdings right now. He compares the HUI Gold Bugs index of gold mining stocks (the only gold index that stretches back into the 1990s) to the price of gold. This ratio shows when miners have the highest and lowest valuation relative to gold. As seen below, the lowest valuation in decades was in December 2015 (blue circle on the diagram). The second lowest was in 2001 (green circle on the diagram) when the current long-cycle bull market in gold literally started. Where we are today is the third lowest relative valuation of gold stocks in the last 2+ decades, at least. Compare today's relative valuation 0.15x to the lows of the 2008 crisis when the ratio only got down to 0.19x (red circle on the diagram); investors have a very pessimistic view of miners at a time when they have upgraded their business efficiency over the last few years. In our experience, these are good times to have large mining investments (which have already moved favorably for us in July).



One more note on gold miners: South Africa, once the largest gold mining country but now falling down in the rankings, has “fired another shot” in its long-running campaign to appropriate wealth for the poor who support the near-Marxist government. The SA government has proposed a law to boost black ownership requirements in all mines to 30%, which does not take into account earlier divestitures by SA miners to black ownership. This is driving further investment out of the country (along with unrest and strikes angling for higher wages by miners) and depressing SA miners’ production volumes and stock prices. We have steered clear of SA miners for years, and we believe this political uncertainty and unrest will dampen current and future SA gold production, further moving the world supply/demand favorably.

Energy

There are two camps in the oil markets that have been fighting over prices for the last few months. The first camp sees excessive inventories in the US and much of the rest of the world (US inventories are much higher on a historical basis) coupled with higher than anticipated US and OPEC production (due to higher production in no-quota Libya and Nigeria) that is building a glut that doesn’t seem to be shrinking during the summer (when demand is seasonally highest). The other camp says that this level of production is unsustainable and that demand continues to build; thus, inventories will start to shrink as demand uses it up and production falls back to lower levels. The inventories were created just before implementation of quotas that started at the beginning of the calendar year, and these inventories take time to work off. Lately, the first group, the bearish camp, has been “winning,” pushing oil prices down to the low-to-mid \$40s/bbl, interspersed with jumps in the oil price provided by the buying of the bullish camp as they see demand pickups and/or large draws on inventories.

From our perspective, we see high stock market prices which appear to indicate rising economic activity around the world and would indicate rising energy demand, and thus, higher prices. However, we also see the weekly US statistics, which on-balance seem bearish as inventories don’t draw

appreciably, while rig counts continue to rise and production levels continue to grow, indicating a glut to us. Thus, we have minimized our energy production investments, allocating a market-weighted amount of capital to throughput-oriented pipeline MLP investments, with high yields and theoretically less exposure to oil prices. Falling inventories, coupled with falling US or OPEC production, would change our mind while appreciating MLP prices would attract more investment from us as well. Also, very low stock prices of well-positioned energy companies with strong balance sheets might get us to invest earlier than indicators would show, if the technical analysis picture, which has been solidly bearish since late 2016, were to move into a bullish set-up.

Bonds

Bonds have been a huge battleground during the year, even though they have not moved much lately. There is one group of investors who believe we have had low rates for a long time, and the Fed has determined it has been long enough. The Fed has already raised short-term interest rates a few times and is planning to start selling longer-term bonds from its balance sheet. Rising short rates (from rate increases) and presumably rising long-term rates (caused by increased market supplies due to Fed bond sales) could cause higher rates across the board. The other camp says that the economy is weaker than the Fed understands, and the recent short-term rate increases have slowed the economy to the point where investors will buy long-term bonds as they see the economy stall and possibly start toward recession. They believe the Fed will not raise rate any higher and will not sell bonds from its inventory because higher rates will cause American borrowers (including the US Government) financial stress. So, the battle lines are drawn, and 10-year Treasury rates have been bouncing around in a tight range (2.30%-2.39%) during July.

We are more in the second camp – we believe the employment statistics don't convey the weak consumer whose purchasing power has been weakened by few wage increases but higher costs and rising interest payments (due to Fed rate hikes). However, we don't think interest rates will fall too far due to inflationary pressures of higher financing, housing, health insurance, and tuition costs throughout the economy. With consumers having a tough time contributing to economic growth, we think the Fed will fold to the pressure and stop raising rates without having sold down many (if any) of the bonds on its balance sheet. With these risks, we continue to buy stocks with high dividends instead of bonds, believing we are in mild "stagflation" where inflation will build but the economy won't expand enough to cause rates to move appreciably higher. The risk of Fed bond sales also keeps us leery of owning too many long-term Treasuries (at least until the Fed reveals whether it will actually sell any bonds or not).

Other Markets

As we said before, we continue to be surprised by the strength of the euro, which pushes down the value of the dollar since it is the largest component in the US Dollar Index.

We sold our short euro/long dollar positions during last quarter as ECB Head Draghi's talk of an improving Eurozone economy and his plan to start to limit the amount of quantitative easing the ECB is currently supplying strength to the price of the euro. We still think the Eurozone will have a hard

time growing with its weak financial state, immigrant problems, large unemployed populations and continued budget deficits in most of its member countries. However, current world markets see Washington's gridlock and alleged scandals as worse for the dollar than Europe's problems. Thus, we will continue to avoid being short the euro but will continue to maintain our short yen/long dollar positions, which have moved back in our favor in early July and approach being profitable for the year. Both Canada and Australia are facing overheated housing markets, which investors believe will cause both central banks to have to raise rates to rein in real estate speculation; this belief in higher future rates has caused investors to buy both currencies, driving them up versus the US dollar. We currently have no positions in these currencies, and we would lean toward being short them (and possibly banks or finance companies) in both countries if their housing booms start to deflate.

Kanos Quarterly Commentary

“Ben Hunt is Right” and “Dimon and El-Erian are Right, Too – Unfortunately”

This quarter, we feel like splitting our commentary and talking about two independent subjects which we believe have effects on the capital markets, world economies and, of most importance, your portfolios. Thus, see our commentary on inflation and US world positioning below. We believe there has been much more inflation that has been measured by flawed inflation readings, and we believe the two following articles articulate one likely outcome to our current monetary/economic situation.

“Ben Hunt is Right”

Ben Hunt is a market strategist, hedge fund manager and financial market “psychologist” who we believe has done the best job of decoding the post-Financial Crisis world of financial motivations for market players. He started, edits and writes part of a website called Epsilon Theory (www.epsilontheory.com) about topics he observes and interprets in the financial markets. He works for a Houston company called Salient Partners from a home office in Connecticut.

Recently, Ben Hunt wrote an article on jobs and inflation that we believe best describes what has happened to inflation over the past few years. The article is called “Epsilon Theory: Gradually and Then Suddenly” [7/13/2017 on epsilontheory.com].

As we have stated multiple times, most economists and investors associate inflation with wage inflation. As such, we are judged not to have had much inflation over the past few years as wages have risen at an anemic pace (due in part to labor rate arbitrage from China and the former Soviet countries over the last 25+years). However, central banks' easy money policies of the last few years were supposed to boost inflation and capital investment through ultra-low interest rates. We also believed that this would occur since historically, extremely low interest rates have always

overstimulated economies and financial markets, eventually leading to high inflation. However, this time, inflation has been slow to materialize as the money has found its way into stock prices, luxury homes, tuitions and things bought by rich people while bypassing wages and, in many cases, commodity prices and other traditional inflation hedges. However, and importantly in the Fed's and markets' eyes, capital investment in plants and equipment has also badly lagged, in spite of the Fed's best efforts. In the past, lower-than-usual interest rates have never failed to stimulate investment, which then leads to more employment and wage inflation. What happened this time?

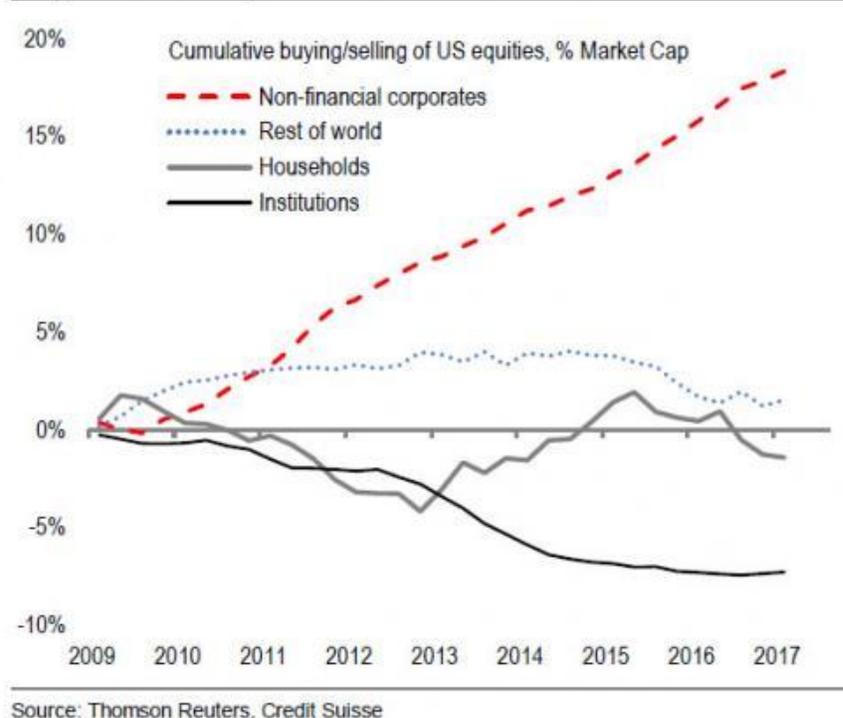
Ben Hunt explains his theory below; it makes the most sense of any explanations we have heard to date [all emphasis by the author]:

“The answer, of course is that answer the Fed will never admit. **The reason companies aren't investing more aggressively in plant and equipment is BECAUSE we have the most accommodative monetary policy in the history of the world, with the easiest money to borrow that corporations have ever seen.** Why in the world would management take the *risk* – and it's definitely a risk – of investing for real growth when they are so awash in easy money that they can beat their earnings guidance with a risk-free stock buyback?...Why in the world would companies take any risk at all when the Fed has eliminated any and all negative consequences for playing it safe?”

The following chart from a recent (July 14, 2017) Credit Suisse report by Andrew Garthwaite shows the extent to which corporate America has used the Fed's easy money policies to borrow money at very attractive rates and buy back their stock (to boost earnings per share):



Figure 63: The corporate sector has been the main buyer of US equities since the market low



Hunt then applies his same principle to wages:

“How does this apply to wage inflation? It’s the same thing. Why in the world would a company pay up to fill a position when it’s a risk they really don’t need to take? Yeah, we’ve got job openings, and yeah, our skill positions are increasingly going unfilled, and yeah, we’d like to expand and grow... I suppose. But, hey, we’re hitting our numbers just fine as it stands and, if you hadn’t noticed, our stock price hit a new high yesterday. Why mess up a good thing?”

Then he follows with how it gets resolved:

“How does this change? As the Fed slowly raises rates ... it will force companies to play it less safe. It will force companies to take on more risk. It will force companies to invest more in plant and equipment and technology. It will force companies to pay up for the skilled workers they need. You want wage inflation? You want productivity growth? Then raise rates!”

And he ends with the punch line:



“In exactly the same way that QE [quantitative easing] was deflationary in practice when it was inflationary in theory, so will the end of QE [raising rates and selling bonds] will be inflationary in practice when it is deflationary in theory. That’s the real world impact I’m talking about, the world of wages and output and productivity...

And here’s my other point. In the Bizarro-world that central bankers have created over the past eight years, raising rates isn’t going to have the same inflation-dampening effect that it’s had in past tightening cycles, at least not into you get to *much* higher rates than you have today. It’s going to accelerate inflation by forcing risk-taking in the real world, which means...that today’s head-scratcher for the world’s central banks – why haven’t our easy money policies created inflation in the real world? – will soon be replaced by a new head-scratcher – why haven’t our tighter money policies tamed inflation in the real world?”

“My view: as the tide of QE goes out, the tide of inflation comes in. And the more that the QE tide recedes, the more inflation comes in. I know that this sounds like a nutty scenario today, with everyone talking about how inflation is dead and gone, and how the Fed will be “fighting” inflation by raising rates, but I gotta call ‘em like I see ‘em.”

These are revolutionary concepts but strike us as accurate. Corporations borrowed virtually-free money from banks and bought their own stock, “inflating” stock prices but not putting money out into the “real economy” (i.e., purchasing plant and equipment and hiring the people needed to build and run the plant). Instead, the money went to stock investors, who having made a profit, reinvested it in more stock, or a luxury apartment or their kid’s tuition to Yale or something else that was pushed way up in price through too much money chasing too few things. And instead of more full-time work in new projects, workers were hired part-time to fill job functions with current production or lines of business. This was also exacerbated by Obamacare – hiring people for less than 30 hours allowed companies to avoid overbearing Obamacare expenses and obligations they would incur with new full-time workers.

These concepts are reiterated in another article, this one published on July 16, 2017 at the Global Macro Monitor: “Market Conditions Are Still Loose As A Goose.” They write:

“Since the Fed began raising interest rates in December 2015, financial market conditions have loosened considerably. Recall our post, [Orwellian Monetary Policy](#), which we wrote in May [2017]: Tightening is Easing...Since U.S. monetary policy began tightening in December 2015, the Fed has added liquidity to the financial system through interest payments to banks on excess reserves and has reduced its surplus to the Treasury, adding to the fiscal deficit. Thus the financial system has had an effective injection of central bank liquidity and a fiscal expansion during a period of monetary tightening.

“The current Fed policy effectively injects liquidity into the financial system through raising the IOER rate – printing money to make interest payments on reserves banks hold



on deposit at the Fed. This compares to the traditional monetary policy where the Fed drains reserves from the financial system to drive the Fed Funds rate higher.

“No wonder then that markets are going bonkers. Take a look at the performance of indicators since the Fed began raising interest rates...The S&P 500 is at an all-time high, up over 20 percent since the Fed shifted to a tightening regime; the 10-year Treasury yield is only up 5 bps [basis points]; the 10s-minus-2s yield curve is 32 bps flatter; the [US Dollar Index] is down -3.12 percent; the VIX is down over 50 percent and closing in on its December 22, 1993 all-time closing low of 9.31...”

This article reiterates the idea that monetary policy has had the opposite effect on parts of the economy than the Fed wanted (or expected). But going forward, higher (short and long-term) interest rates and already high debt loads will force companies to further expand their earnings the old-fashioned way – through new, more efficient facilities, technology and services, which will almost certainly require more commitment, more skilled labor and more risk, just as Ben posits above. And very interesting will be the central banks’ reactions to how things shape up.

We are very aware of the inflation that has occurred but not been measured well by government statistics. We will continue to invest in solid assets with good cash flow and distributions that we believe will survive or even thrive in inflationary times. With these insights, we believe we have a better working knowledge about how the story could unfold. Stay tuned.

“Dimon and El-Erian are Right, Too – Unfortunately”

Jamie Dimon is the ultra-successful CEO of one of the largest banks in the world, JP Morgan. However, he often gives self-serving advice/comments that mostly benefit Dimon himself or the big banks that he unofficially speaks for in his role as head of “The House of Morgan.” However, Dimon surprised the financial world (and us) when he said,

“It’s almost an embarrassment to be an American citizen traveling around the world and listening to the stupid shit we have to deal with in this country [meaning the US] and at one point we all have to get our act together.”

People were taken aback by his frankness, and although he got some support for his statement, there were others who labeled him unpatriotic for his words.

On July 17, Mohamed El-Erian, currently senior advisor to German mega-insurer Allianz SE and former CEO of both Pimco and Harvard Investment Company, wrote a column for Bloomberg that we think was insightful and worth sharing. El-Erian wrote:

“Put in a proper context, the comments speak to four consequential realities in the U.S. and global economies:



1. Dimon's main worry, which is rightly shared by many in this country, is that by unnecessarily increasing contextual uncertainty and delaying the implementation of sensible economic policies, political gridlock in Washington has for years undermined growth, made it less inclusive, and denied many Americans the higher level of prosperity that is both desirable and feasible.
2. Dimon was correct in observing during the call that, despite the "dysfunction" in Washington, the U.S. economy has still managed to deliver annual growth in the 1.5 percent to 2 percent range -- an outcome that illustrates the resilience of the private sector. Yet the longer this low growth equilibrium persists, the greater the downward pressure on the country's potential and its future prosperity.
3. Given the role and importance of the U.S. in an interconnected global economy, much of the rest of the world -- and especially America's friends and allies -- has gone from looking at this situation with curiosity and bemusement to confusion and concern. For decades, America's traditional values, institutions and entrepreneurship have been the source of inspiration for efforts to improve the well-being of many people around the world. And America remains a very important growth locomotive for the global economy, and its most important anchor of financial stability.
4. American credibility and leadership still form the most critical elements for effective global policy coordination. Without them, the global economy will be subject to the uncertainties and challenges that come with greater fragmentation pressures, including the redefinition of regional economic orders that will be difficult to add up well at the international level.

“It is one thing for foreign business and government leaders to express concern about the damage of U.S. political dysfunction. It is quite another for such comments to come from one of the country's most influential and respected CEOs. In doing so, Dimon rang an alarm bell about both foregone opportunities at home and eroding influence internationally.

“The timing of Dimon's remarks also was important.

“Delays in formulating and passing pro-growth legislation (such as tax reform and infrastructure investments), together with the diminishing effectiveness of Federal Reserve policies in continuing to buy time for the economy, expose the U.S. to a higher risk of a downward drift. The low level of global policy coordination, as illustrated most recently by the outcome of the G-20 meeting in Germany, would make the potential economic, political and social consequences of such a move even more disturbing were it to occur.



Rather than dismiss Dimon's remarks as unpatriotic and the product of an unfortunate outburst, the nation would be best served if they were to provide a wake-up call for Washington, which remains divided and distracted, and continues to fall short in stepping up to its important economic governance responsibilities.”

We believe this is right “on point.” The Republicans need to caucus and find enough common ground to get an economically helpful and effective tax plan together that would prove difficult for Democrats to ignore. To us, the Democrats’ tactic of constant attacks on Trump will only be successful if they can come up with an alternative plan that makes sense to Americans. So far, they haven’t come up with a real alternative. This leaves the Republicans with the impetus to craft a tax strategy that will help enough Americans to get it passed and help revive this economy, which, as we said above, is weak enough to be pushed into recession by outside shocks without new stimulus – a tax plan that makes sense for the long-term and helps out the largest number of Americans, would do so.

This is important because America needs an improved tax system to grow its economy on a sustained basis going forward. Easy monetary policy has provided a large amount of “fuel” for the current bull market, but only earnings produced from a growing economy will improve the US companies’ earnings which are fundamental to a higher stock market and growing the wealth of Americans of all economic situations. We hope those in Washington will understand the importance of underpinning the economy with smart tax policy before investors grow cautious of Washington’s machinations and withdraw investment money from the economy and markets, causing a recession or worse.

The Managers of Kanos Capital Management

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