KANOS
CAPITAL MANAGEMENT, LLC

First Quarter 2018 Investor Letter

We are finalizing the implementation of our new tracking and analysis system this spring to better serve you. You will continue to receive this Kanos Investor Letter with our forward-looking market analysis and Market Commentary. In addition to this letter, you will receive a Performance Report, which includes your portfolio's performance, composition and make-up and quarterly transactions. It also contains the synopsis of the quarter's market moves and some notes about our portfolio's performance.

Market Analysis - Looking Forward

The US stock market has been considered the best potential developed market worldwide due to the strong US economy, the lowered corporate tax structure and the resultant earnings gains. The US Federal Reserve (the Fed) is only gradually raising interest rates (still at very low levels and signaling rate rises far in advance) while lowering overall liquidity (its QT program is withdrawing liquidity on a standardized schedule). It was planned to work out to allow the markets to continue to advance while preparing the Fed with some "ammunition" to fight an economic slowdown in the future.

But a funny thing happened on the way to the forum……economic announcements have started to uncover US economic weakness. Earnings announcements, which have been decidedly positive, have shown that the good news has been priced in and therefore led to few gains for earnings beats and horrible performances for earnings misses.

Economy

During the first quarter of 2018, there was widespread agreement that the US economy and most of the world's economies were growing nicely. However, the last couple of months have seen less robust economic statistics, seemingly indicating a slowing economy. First and foremost, short-term interest rates are much higher than in 2017, with Two-year Treasuries trading at 2.45% (up more than 31% this year alone) and Libor, the worldwide short-term interest rate used by most businesses and many commercial and residential real estate loans, up to 2.35% (up almost 40% this year)! Rapidly rising interest rates are a burden for the economy which has been fueled by debt financing over the past few years, but rises of 30-40% in less than a year are significant! In addition, inflation is now high enough that is registers in the inflation statistics. The consumer price index (non-seasonally-adjusted headline CPI) was last reported at 2.36%, diversified commodity indexes are 6-7% higher year-to-date (only 1/3 of the way through the year) and oil is 15.5% higher y-t-d – all showing higher prices affecting the economy and causing corporate profit pressure and some slowing of economic activity.

We believe the tax bill passed last December is still working its way through corporate America and through the US public, almost certainly still providing some extra stimulus. But removed tax breaks for

1217 South Shepherd
Suite 200
Houston, Texas 77019
www.kanoscapital.com

wealthy Americans, like the severe limitation of the deductibility of state-and-local taxes ("SALT"), will limit typical tax-break implications for the wealthy, who are typically much more important to the investment cycle for the US economy.

Finally, one prominent market indicator of recessionary fear – the steepness of the US Treasury yield curve (typically gauged as the yield differential between ten-year and two-year bonds) – has dropped to 0.43%, which shows the Fed raising short-term rates faster than the market is pushing up long-term rates. This shows the market is less sure of a lasting economic expansion, so long-term rates have gone up far less as some still seek the safety of fixed income.

Thus, we see the economy as expanding but possibly not expanding as fast as earlier thought, meaning we might have seen peak earnings already, or we will in the next quarter or two. We will continue to monitor economic indicators closely, but we have started to adjust portfolios to reflect a more "stagflationary" (rising inflation in a slow-growth economy) stance.

Equities

As I am sure you all know, almost all stock market indices peaked on January 26, followed by a period of rising volatility as investors re-evaluated profit outlooks for companies, taking into account the new tax rates but also high valuations and the emergence of some indicators of above-target inflation pressures. Since the nearly across-the-board rise of stocks in January, individual sectors of the stock market have acted very differently. The former leaders, technology and financials, have underperformed, with tech basically flat despite big tech beating hugely on earnings, and financials giving back all of January's gains and more, despite higher long-term rates (which had served as a catalyst for financials to rise during 2017). Meanwhile, recent winners have been: 1) energy stocks which have recovered February's big drop and more, gaining 3% for the year so far, 2) utilities, which were down almost 7% in February but are now basically flat, and 3) healthcare, which has managed to recover to unchanged twice in spite of all the market turmoil seen so far this year.

We continue to favor these last three more defensive sectors going forward, feeling like the big, expensive winning stocks of the past few years have their future success already priced in, while the less in-favor sectors and companies still have upside to their stock prices. We will continue to overweight our industrials/defense stocks due to the continued need for military spending increases worldwide to make up for past underspends and for looming future wars, precious metals/materials to address growing inflationary pressures and a very highly valued stock market in the face of rising rates/falling Fed liquidity, and biotech due to advances in medicine that will lead to higher valuations and acquisitions.

The overall positioning of the stock market appears negative, but we are at a point where one cannot definitely judge whether the market is at the end of a severe correction or at some resting point before heading lower. We believe our positioning will be profitable for you, our customers, regardless of the outcome, because we feel like our investing themes still have room to run, and we have underweighted or omitted some higher risk positions that could send the market (and more aggressive portfolios) lower.

Bonds

We have devoted our Kanos Commentary below to the bond market, so we will give just an abbreviated positioning discussion here.

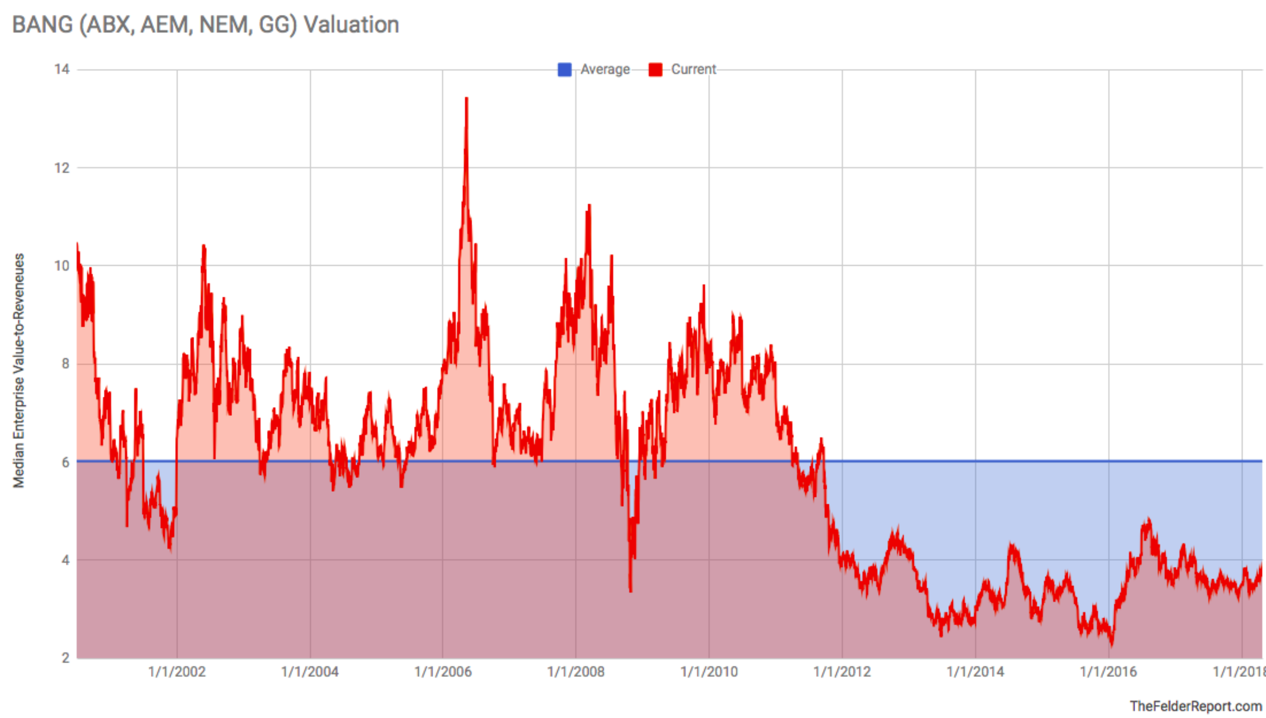
We see bonds as being less attractive as short-term yields rise (pushing down the value as rates rise). We believe the large amount of bonds outstanding plus the anticipated increases in issuance by the US Treasury means that there will also be pressure on long-term rates. We favor equity yield-stocks which we believe will be better at adjusting to a growing inflation and uneven economic growth we see in the future. We also think that after a roughly 35-year bond bull market, younger managers are less equipped to handle downward moves in bonds, especially if they are big moves; if bonds drop quickly, there could be dislocations in the bond markets, which would spread to equities and other markets.

Commodities/Precious Metals

Commodities have added to their first quarter gains as oil prices have resumed their rise and some metals continue to be in short supply, like nickel. Other industrial and precious metals have corrected some of their gains from earlier in the year as people see the economic strength around the world in the first quarter slowing. We are still bullish on commodities due to our analysis that inflation will continue to build and that investments in commodity sources (mines, etc.) have been minimized due to the severe bear market in commodities that occurred from 2012-2016. The bear market, which was caused by slow growth in worldwide economies that took far longer to recover from the 2008-2009 financial crisis than in early recessions, translated into the stock market where managers desperate for growth concentrated their investments in technology and healthcare, while value managers invested in large multinationals with less growth but relatively large, steady dividends (compared to 0% interest rates). Industrial and commodity companies, which rely on faster economic growth but have less predictable earnings growth, were left out of the boom, hurting stock prices and starving these sectors of capital. Now, mine discoveries are few-and-far-between and yearly production rates of many commodities are dropping. As supply situations have grown tighter, the rising economic growth around the world of the last couple of years has raised demand, putting upward pressure on prices.

As you know, we favor precious metals investments as our preferred way to benefit from the growing bull market in commodities due to their ability to react to changes in monetary conditions (resumption of Fed easing in the future), government instability and global geopolitical turmoil (this has definitely contributed to gold's 30% rise off the bottom since late 2015) and its falling supply dynamics (no major gold deposit has been found in the past 5+ years and mines take up to 10 years to develop these days).

Gold mining equities continue to be the best risk/reward holdings in our portfolio, as the miners continue to improve their mining operations and yields (and thus earnings) while the market only grudgingly recognizes these gains. Jesse Felder, analyst and publisher of the widely followed investment newsletter, The Felder Report, on May 5th wrote an article on gold miners, noting that valuations (in the form of median Enterprise Value/EBITDA, which allows you to ignore individual companies' debt burdens) are much lower now than at the prior valuation trough in gold prices in 2001-2. In the graph shown below, the median EV/EBITDA of four of the largest North American gold miners, Barrick Gold (ABX), Agnico Eagle Mines (AEM), Newmont Mining (NEM and the only gold miner in the S&P 500) and Goldcorp (GG), is less than 4x! In other words, these companies' earnings are enough to pay back owners/borrowers in four years, a very short time during an era of near zero interest rates. In comparison, according to Investopedia.com, "The enterprise value-to-EBITDA ratio varies by industry. However, the EV/EBITDA for the S&P 500 has typically averaged from 11x to 14x over the last few years." Therefore, a 4x ratio is extremely cheap and rare, and attractive for building positions.



Precious metals miners had a very poor March, leading to poor performance stats for the first quarter, but in April and early May, they have led gold and silver prices higher on a consistent basis, so we believe precious metals will appreciate during the rest of 2018. A higher dollar has helped hold back the gold price, as has continued strong gold sales by the Venezuelan central bank as the communist Venezuelan government continues to turn everything available into cash in order to buy consumer staples as their economy implodes under price controls and shortages of human essentials. Venezuela has sold the vast majority of their gold, so we see this pressure abating in the future. We also think that the demand by non-dollar buyers looking to protect their purchasing power from the continued money growth in Japan and Europe will help propel the price higher in all currencies, attracting dollar-based buyers in the future.

Energy

It has been amusing for us to observe the financial press' consternation at stubbornly high oil prices, while in the next breath they are crowing about very low unemployment, the US economy and corporate profits booming, rising inflation that is starting to concern the Fed, and the "global synchronous expansion," which could not happen without a voracious appetite for energy, and in particular, oil. While the popular narrative-makers have failed to connect-the-dots on the demand side, they also seem to have missed that Venezuela is descending into real chaos, and the progression to that state has resulted in the looting and poor care of PDVSA, the national oil company. Thus, production has dropped below 1.5 million bbls/day, from 3.5 million bbls/day in the early 2000s. Despite gains from the US "frackers", Russian production, Iraqi production and other Middle Eastern sources, it appears that most sources are operating at maximum or are being held back for pricing purposes (Saudi Arabia to IPO Saudi Aramco later this year?).

We are leery of prices continuing to climb because of our uncertainty about maintaining strong worldwide economic growth, but we also feel like the underperformance of energy stocks in the past 4-5 years have led people to have lower exposures and at lower valuations, so they are a much "safer" position to hold, especially since many pay handsome dividends. We have built positions in major and large independent oil companies, eschewing more volatile companies that have flirted with bankruptcy but show rapid appreciation during the recent oil price rise. However, we also believe that low oil prices from 2014-16 have led to underinvestment during that period, so supplies won't be growing quickly around the world – leading to prices that could maintain the $60-75/bbl range for longer than many think.

Natural gas seems like it is plentiful in the US and growing more so as more oil wells are produced and associated natgas finds its way to the market. Despite it being a more attractive fuel in the US and its demand growing again around the world in the form of liquified natural gas (LNG), we still think that it is hard to make money in production or pipeline companies as gas-on-gas competition continues to keep most companies from making large profits. The technicals seem to confirm this as natgas producers and MLPs with a natgas focus continue to disappoint in their charts.

Currencies and Other Markets

Although the US dollar was weak for most of first quarter, it has been stronger for most of the second quarter so far, as interest rate differentials (US rates are far higher across the curve compared to European and Japanese counterparts, especially when figuring credit quality) have proven to finally matter. The dollar is higher versus the Japanese yen and the euro, and with Mexican elections looming on July 1st and Lopez Obrador currently still ahead in the polls, the peso is weaker.

We believe the dollar will continue to prove the "cleanest dirty shirt" and that the euro and yen will continue to weaken against it, especially since the Bank of Japan (BOJ) and the European Central Bank (ECB) continue to buy bonds, artificially maintaining low long-term interest rates and producing more and more excess reserves, further bloating their balance sheets with yen and euro assets. We have on a short yen position and could add a euro short at any time.

Bitcoin, as the best known and most liquid of the cryptocurrencies, is the de facto marker for how cryptos are faring. Having peaked in December 2017, bitcoin dropped throughout the first quarter, bottoming in early April around 6500. Since then, it has retraced some of its large drop, hovering between 8800 and 9500 for the past couple of weeks. It looks poised to move higher but could run into price resistance as it tries to get through the round 10,000 price barrier. We might invest in these cryptocurrencies if they prove that a bull market has resumed.

Kanos Quarterly Commentary

A True Paradigm Shift

We periodically read articles or books that claim that a paradigm has been shifted. This is usually defined as a typical sequence of events being altered (usually by some new technology) which the author claims will change the way the sequence works permanently. While sometimes this change actually does occur, it is usually more of a minor alteration than a major change.

However, when a 30+ year trend changes, it feels a lot more "permanent" to us humans, especially in the financial markets, where 366 days is sometimes considered long-term. The paradigm we will be discussing is the riskiness of long-term U.S. Treasury notes and bonds. Since the mid-1980s, bouts of extreme weakness in the stock market led investors to sell stocks and "park" their investment capital in "safe" long-term Treasuries, which they felt were assets that would hold their value in times of market turmoil due to their credit worthiness, appeal to foreign investors due to US political stability, the Fed conquering of 1970s inflation causing an ongoing bond bull market and perceived US financial stability.

In a speech to DoubleLine Capital investors in January, Chief Investment Officer Jeff Gundlach predicted that in the next recession, "we won't see a bid for safety out of stocks and into bonds (like we've seen for the past 30+ years." ***Addended by KS***). Not a lot was made of the prediction at the time, but only a couple of weeks later, stock markets were roiled by rising inflation readings and expectations of further inflation rises, causing a large correction in stocks. From its intraday high on January 29th, the S&P 500 (representing the US stock market) dropped approximately 11% peak-to-trough. During the same time period, long-term US Treasuries (as represented by the TLT exchange-traded-fund, the iShares 20+ year Treasury Bond ETF, fell 4.37%, roughly mirroring stock market moves (but obviously with less amplitude). A more minor correction during mid-April, when the S&P 500 dropped almost 4% over approximately 7 days, long-term US Treasuries dropped approximately 2.5%. DoubleLine's Gundlach has been proven right – how did he correctly predict this? We think the main reason is that the Fed is systematically divesting Treasury positions at an accelerating rate. During this most time of market turmoil, the Fed is not only raising short term rates (tightening conditions), but its quantitative tightening program (where the Fed is no longer buying Treasuries maturing in its portfolio, removing a bid that has been in Treasuries for most of the last nine years) is also tightening conditions, leading large institutions to mirror the Fed and reduce their exposure.

There are several implications. The first is that there is now more pressure on rates going higher in general because one of the big, longstanding bidders in the Treasury market, the Fed, is gone; as stated above, many institutions will copy-cat the Fed and reduce any plans to buy Treasuries in their current investment plans.

Bear markets in stocks often occur because of a shock or because of slowing/recessionary business conditions. If stock market investors with discretionary investment authority don't believe bonds are an alternative during a crisis, the "self-correcting" nature of lower rates due to risk-reducing investors buying bonds during a downturn will not appear, meaning rates will stay higher than they would in past bear markets, saddling the economy with rates that will be higher relative rates than in past downturns.

In addition, the Fed has raised short-term rates a number of times in the past couple of years and is signaling at least 3-6 more rate hikes over the next couple of years. The resultant higher short-term rates will lead more people to leave money in cash, further starving the Treasury market of fund flows that would normally be expected to move to Treasuries and push down rates.

Falling interest rates over the past several decades have been a tailwind for asset holders, both bondholders and debt-financed assets like real estate; as rates fell, those assets rose in value. Now, if rates are rising, and investors see their assets falling in value over time, they may be in more of a hurry to sell, adding another force pushing on valuations and thus, rate levels.

Finally, the knowledge that bonds are probably not going to be a viable alternative should unfortunately lead to more risk-averse positioning by pools of money, which will require a smaller overall allocation to stocks (leading to ongoing selling pressure in the markets) and more panic-y selling in the stock and bond markets during volatile times, like we saw in February 2018.

We had reduced our Treasury positioning to minimum levels before 2018, and we are leery of bonds in general due to: 1) the Fed's QT program which is occurring at an accelerating pace, 2) the market for international currencies is such that international investors are not incentivized to buy US Treasuries, even though the rate differential (US rates look more attractive than either Japanese or European sovereign bond rates, before currency hedging) makes things look attractive, and 3) inflation has been noticeably rising during 2018 which makes almost all bonds with 5 years of duration or less a net loser when inflation-adjusted.

We will continue to look to add diversifying investments to our portfolios that are solid situations with payouts that can adjust with inflation over time. We believe a large portion of the market that is slower moving and running the time-tested "invest in stocks, but when stocks go down, switch to bonds" is going to be surprised at the negative results, which we believe will drive them into our yield investments, in which we are currently building positions.

The Managers of Kanos Capital Management