KANOS
CAPITAL MANAGEMENT, LLC

Second Quarter 2018 Investor Letter

We are finalizing the implementation of our new tracking and analysis system this summer 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 shown resilience after t volatility in February/March, buoyed by continued strong earnings growth (helped by the December tax cut), strong employment and rising incomes. This near-"goldilocks" situation is offset by a few factors. The US Federal Reserve (the Fed) continues to raise interest rates to limit inflation and moderate growth as they raise interest rates from still historically low levels. Tough trade and tariff discussions are leading to disruptions of trade and rising prices. Finally, the strong US dollar has caused inflation, rising interest costs and unrest in a number of developing countries, hurting expectations for overseas growth and profitability. The key to US markets will be the continued growth of profitability – if growth stumbles, the market could reprice profit expectations.

Economy

The US economy sped up to a 4.1% real growth rate, its fastest pace in many years. A combination of tax cuts, catch-up capital expenditures and increased government expenditures combined to help the American economy really hit its stride. For the time being, despite an aging business cycle & bull market, a still-strong economy continues to "chug along" buoyed by extra "oomph" from the tax cuts this year. However, the Fed has already declared that the economy is hitting on all cylinders, and higher short-term interest rates and accelerating Quantitative Tightening ('QT,' where the Fed is shrinking the bond portfolio on its balance sheet by not rebuying maturing securities) will continue, trying to slow down the economic exuberance shown in recent economic statistics. We believe the 'double whammy' of Fed tightening and lack of bond purchases, combined with more debt being incurred by the US Government and corporations, will gradually slow down the economy going forward. Part of the reasoning for this is the imposition of tariffs with several trading partners, which tends to slow trade not only because of reduced competitiveness (higher prices due to added tariffs) but also from reduced commitments to future trade plans due to uncertainty about future tariffs or trade structuring.

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Europe and China are the other economic wildcards. We see the European Central Bank (ECB) trying to lower its dependence on Quantitative Easing ('QE,' or buying bonds to lower short-term interest rates) but having a tough time doing so as trade stagnates (slowing the German economy) and political turmoil leads to uncertainty and reduced business activity in Italy and Spain. We think the ECB will have to continue its QE program as it continues to support 'zombie companies' (which avoid bankruptcy due to cheap continued financing from the ECB and banks buying their bonds), and the resultant inflation (led by higher oil prices) continues to crimp profits. China is facing the same factors as Europe – trying to expand the economy in a time of trade uncertainty. Internal demand has still not grown enough to support the Chinese economy, but with the US in a trade war with China and the higher US dollar hurting emerging market economies (dollar-denominated debts getting more expensive, lower currency prices mean imports more expensive, making expenses [and inflation] rise). We see both of these large economies plodding along, vulnerable to a shock that could send them into recession, but otherwise continuing the slow growth that has plagued them recently, leading to continued stimulus from governments/central banks. Japan, after expanding for the last few quarters, also seems to be sliding back to near-zero growth as the economy stagnates. With trade deteriorating due to tariff concerns worldwide but few countries engaging Japan in the conversation, Japan could keep at least a small amount of growth going by picking up some trade from tariff-encumbered countries.

Emerging markets countries, along with developed commodity producers like Australia and Canada, continue to supply the developed world with raw materials, providing strength to economies with poor internal demand while facing inflation and rising financing bills from a higher US dollar (more expensive imports). These countries should continue to expand as long as developed world growth continues, but they are vulnerable to violent downturns if their exports start to drop. In fact, we are currently seeing some real turmoil in Turkey where recent development was financed with US dollar-denominated debt, and as the dollar has risen, the Turkish lira has plummeted, down almost 70% year-to-date. This is leading to more and more distress for the Turkish borrowers (dollar debt is 70% more expensive than last year (!), the lenders (mostly European banks – they are now facing higher and higher default rates at a time when they have low capital reserves and the Turkish citizenry (they are facing sudden, debilitating price rises due to the plunging lira). Will this be a canary in the coalmine for defaults around the world? Stay tuned.

Equities

Equities in July have already recovered from their late June swoon to move higher during the month, with the Nasdaq hitting a new all-time high on July 25th. The US markets have shrugged off a number of negatives, including Washington rancor, tariff distortions/uncertainties and high valuations. However, recent sell-offs in large tech market darlings after earnings disappointments have somewhat tempered enthusiasm. So far, the US markets have held up as rotation from expensive tech stocks has moved to less expensive value sectors like energy. Some earnings expectations have gotten a little too far out in front of earning realities, leading to a revaluation period for some of the high-fliers. We believe markets will weakening in August and September but possibly powering higher in the fall as midterm election expectations crystalize, the seasonal pattern of recent years. We think the market could weaken as the economy weakens (reasons mentioned above) and profit/growth expectations fall short. However, we do feel either outcome of the midterm elections is probably market friendly in November-December: 1) Democrats take one or more houses of Congress, leading to legislative deadlock (which the market likes

due to the inability for the politicians to make mistakes) or 2) Republicans keep both houses of Congress, leading to more business friendly policies, such as the second part of the tax cuts and more friendly Fed (Trump to appoint more Governors to the Federal Reserve Board).

European stock markets have been moving in lockstep with US markets, likely due to the effects of ECB QE affecting stocks favorably on both sides of the Atlantic. If US equities are going to correct and later move higher, European stocks will probably follow, especially due to their generally lower valuations and relative competitiveness (lower euro). However, if the euro gains in value versus the US dollar, European stock prospects would fall. If the weaker European economies (Italy, Spain and eastern Europe) falter, stock prices could follow, regardless of the ECB stimulus, as investors would probably rotate investments to the US.

Chinese stocks have fallen for much of June and July due to export concerns, causing Chinese monetary authorities to engage in an orchestrated devaluation of the yuan to maintain price competitiveness worldwide. However, a lower yuan invites higher inflation (higher import costs, especially raw materials [oil, copper, iron ore, etc.] denominated in US dollars) and encourages capital flight (Chinese trying to maintain purchasing power by buying foreign currencies, hurting the Chinese capital account). Both actions contribute to a rising internal unrest with President Xi and the government. It also makes the Belt & Road initiative more expensive as the yuan buys less, thereby hurting future Chinese growth prospects. China should be motivated to working out a new trade framework with the US to restart growth prospects, but politically, it cannot be seen as succumbing to US pressure. It will be really interesting to seeing how this situation resolves itself. Japan has also stagnated, while its stock market has held up pretty well lately; unless the Japanese economy starts to grow again, we think equities in Japan are dead money for the time being.

Emerging markets have been hammered as a higher US dollar has taken its toll on foreign US dollar-denominated debts and rekindles inflation. The usual suspects of Argentina, Turkey, and Brazil show the carnage that the rising dollar has had on emerging economies, although stock prices seem to have stabilized somewhat in late July. While there is probably a good risk/reward in some of the companies in these countries, we think that they are still vulnerable to a selloff if developed countries have more of a selloff. We will steer clear of Emerging stocks for the time being.

Bonds

Longer-term Treasury bonds hit their year-to-date lows in February and then bounced at the same levels again in May, possibly marking a high in interest rates, as short-rates and long-rates converge, signaling a possible economic slowdown. As of the writing of this letter, one traditional measure of the Treasury yield curve, the difference between two-year Treasuries and ten-year Treasuries, has shrunk to 28 basis points – really only one short-term Fed interest rate hike away from being flat or starting to invert, a condition which has preceded every recession for the past few decades. Even more surprising, the 2 year/30-year Treasury yield difference has dropped to 39 basis points, the lowest since June 2007. This comes at a time when the US budget deficit is slated to rise (requiring more borrowing) due to the initial impact of the tax cuts and China, Japan and Russia have recently been net sellers of Treasuries. Despite

all of the above, Treasuries look to rise during the quarter as investors buy them for stability and guaranteed yield.

Junk bonds, as represented by the ETFs HYG and JNK, have shown volatility but held their levels during the last few months, bolstered by a strong energy sector showing investors' attraction to their yields and seniority to equity in capital structures. Investment grade bonds have not held up as well, due in part to large issuances this quarter.

For the rest of 2018, we see short-term bonds as a reasonable place to get yield and safety, as the Fed continues to raise rates (giving 0-2-year bonds even better yields). We will see whether the economy will continue to grow, despite the aging business cycle/bull market described above.

Commodities/Precious Metals

Gold has carried its second quarter weakness into July, this time dragging precious metal mining stocks and silver down with it. The second quarter is usually seasonal weak, as demand lags; in this case, the weak Chinese yuan seems to have pulled down metals prices, probably due to Chinese being the largest buyers of gold presently.

However, technical and sentiment factors point to a strong recovery, so we continue to maintain our exposure. These factors include:

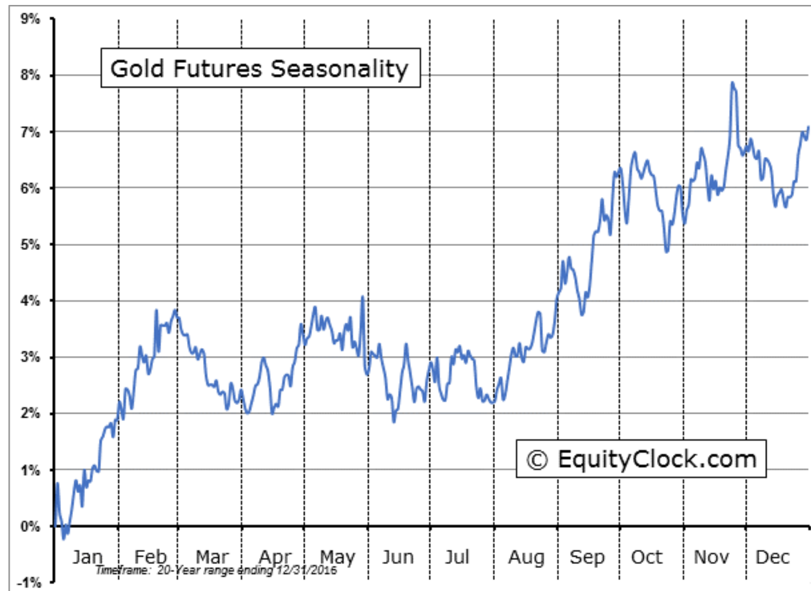
1) The most bullish positioning in gold futures by the commercial traders (generally considered the "smart money") at the same time as the most bearish positioning by speculative traders (generally trend followers – typically most extremely positioned at turning points) since December 2015/January 2016, the low of the last decade (prices are far higher currently $1225/oz vs. $1045/oz in 2016). This marks a point of extreme sentiment, a major determinant of price in the precious metals markets;

2) The speculative fervor of the long growth/momentum vs. the short value/safety trade has hit similar extreme highs in July just like happened in December 2017, when gold went from $1238/oz to $1365/oz in four weeks. The growth/momentum trade has just "broken" with the huge drops in Facebook and Netflix during July; a rotation into value and safety is occurring;

3) Silver has been outperforming gold since gold's highs during the spring; bull markets in precious metals are usually led by the more speculative elements: silver and mining stocks;

4) Mining stocks, while weaker in the past couple of weeks, have been much stronger than gold during the past couple of months, again showing another signal of a budding bull market; and

5) Seasonal patterns generally show gold showing weakness in June/July and higher prices in August – November (see chart below for the 20-year chart from EquityClock.com):



Finally, one final anecdotal but strong indicator to support our thesis of extreme sentiment subject to imminent change: Vanguard, one of the giant mutual fund/ETF companies, just announced they will rename the $2.3 billion Vanguard Precious Metals and Mining Fund to Vanguard Global Cycles Fund. Fred Hickey, noted high-tech analyst and precious metals investor, tweeted the following on 7/27/2018: "'The $2.3 billion Vanguard Precious Metals and Mining Fund (VGPMX) will be renamed to Vanguard Global Capital Cycles Fund a s part of a restructuring intended to broaden the fund's mandate and diversify its portfolio.' They don't ring bells at the tops& bottoms?" The last sentence reflects the thought that Vanguard is reacting at an extreme low of sentiment to abandon a "bombed out" sector. As Gary Kaltbaum (@GaryKaltbaum) commented on Hickey's tweet: "At the top in late [19]99, many funds changed name to include 'internet' in them." That marked a top in sentiment; the Vanguard announcement of last week appears to mark a bottom. When sentiment bottoms in so many measures, there are usually few sellers left. Meanwhile, buyers start to notice the bargain valuations and high upside, leading to buying interest, higher prices and a covering of short positions which leads to more buying.

In addition to sentiment and technical indicators, the price of mining gold continues to rise due to rising fuel, labor and materials costs. The cost of mining an ounce of gold has risen an average of $1,000 – 1,300/oz worldwide, so we believe a break below these levels would be short-lived at best, as recent statistics reported by a number of sources has the production of gold dropping for the next 2-3 years (at least) as these current low prices, coupled with the roughly ten-year development time required for precious metals mines, has not incentivized enough new mining to maintain current production levels.

Despite the moves in gold, some mining stocks that we own have recently (in July) hit 52-week highs. Clearly, some buyers have already identified good companies and price momentum. While these companies have recently shown some weakness, they are still bargains with great prospects, good management and good general price action.

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Energy

Energy has been extremely interesting in its ability to NOT go down. Pundits across-the-board have been calling for lower oil prices due to: overproduction by US shale producers, a pickup in production by the Saudis and other Persian Gulf states, perceived economic "soft patches" in Europe and China, etc. However, oil prices have barely corrected from recent highs, and at press time, we see West Texas Intermediate prices back near $70/barrel. Why? The answer can only be demand – there has been no slacking of demand, regardless of analyses that predicted the opposite. Demand continues to "feel" strong, as expressed by continued steady price backwardation [prices for the near future are more expensive than prices for the distant future, showing consumers "incentivizing" present sales by producers over future sales] and a continued drawdown of worldwide supplies, moving from an all-time high two years ago to a five-year low in inventories currently. Add in some supply concerns from plummeting Venezuelan production (down below 1.5 million bbls/day from over 3 million ten years ago), the new US sanctions limiting Iranian sales and hiccups in Libyan and North Sea production and you get a higher than predicted price curve. We don't see any reason for the balance to change significantly – the US economy should continue to grow (even if it weakens somewhat). Meanwhile, developed world economies might ease from current levels but probably be replaced by (more energy-dependent) emerging world economies. Thus, we believe oil will stay in its $60s – 70s/bbl range for the third quarter.

Natural gas showed strength into the end of the second quarter, but it has since retraced much of its latest move upward, ending below key technical levels and looking like weakness is the order of the day. We remain neutral on natgas.

Currencies and Other Markets

As discussed above, tariffs and a more unsettled trading environment worldwide are major themes this summer. One major way that countries adjust to changing trade flows is by adjusting the level of their currency. Throw in that there is talk out of both the ECB and BOJ that they will slow their level of bond buying, and there are several major forces affecting currencies worldwide.

Our views are as follows: first, we see the dollar as continuing to be one of the stronger currencies in the world, although it has been somewhat undercut this summer by US stock market weakness. On the flip side, the Chinese yuan has been weak since tariffs were first imposed, with the yuan at lows not seen in many months; we see this as continuing (as China fights tariff-caused trade weakness with competitive devaluation). However, we think the yuan will have to bounce from its oversold condition, possibly as early as August, because the Chinese cannot let the yuan fall too much and cause inflation to grow.

The yen and euro were weak during the second quarter of 2018 (due to the strength of the US dollar), but they could strengthen during the rest of 2018 IF their respective central banks set a timetable for reduced quantitative easing, as has been hinted. Otherwise, we see the weight of more and more money creation pushing down these currencies over time.

The most interesting part of foreign exchange is the emerging markets currency arena. They have suffered mightily due to a strong US dollar during much of 2018. If the dollar weakens and/or their economies are helped by commodities production needed in the still-expanding economies of the developed world, many of these could improve, which could also help developed world currencies like the Canadian and Australian dollars and even the Russian ruble. However, a stronger dollar is a more probable outcome; a stronger dollar will continue to put pressure on interest payments denominated in dollars but borrowed by emerging markets companies and governments. As mentioned above, the Turkish financial crisis could be repeated in other countries if the dollar continues to strengthen.

Kanos Quarterly Commentary

The Market and Market Signals

Recently, I was looking at some articles about the "yield curve," which is the curve formed when the yields of Treasury bonds are graphed according to their maturities. Generally, the longer maturities (10-year notes and 30-year bonds) have higher rates to compensate investors for higher risks (mostly interest rate risk) inherent in longer-term bonds. Thus, the yield curve generally slopes up and to the right. When the curve inverts, shorter rates are higher than longer rates (the curve changes slopes to "down and to the right"). This happens when the Fed is keeping short-term rates relatively high, and market participants nervous about financial markets and increasingly invest in long-term Treasuries at relatively low rates for their safety, stability and (semi)-attractive yields. Inverted curves usually occur before recessions or near-recessions.

Currently, the US Treasury yield curve, measured as the difference between the 2-year and 10-year Treasury notes, is 25 basis points. Meanwhile, the Fed has signaled that it will almost certainly raise short term interest rates at least twice more this year, pushing short rates up 50 basis points. If long rates stay where they are (which could happen if the economy doesn't improve from here), or if they fall (both of which could happen if the US economy or a number of world economies weaken), then the curve could invert in the next month to four months. Many economists consider an inverted yield curve a forerunner to a recession, so part of the markets and financial economists have an eye peeled for slowing economic statistics.

But several market watchers feel like this time is different. Below you can see a number of articles I uncovered as I looked for stories on the yield curve. Most of the stories right now resemble these:

Yield Curve Inversion: Not What it Appears by Steven Vannelli of Knowledge Leaders Capital, Jul 19, 2018

Inverted Yield Curve & New Recession? - Probably Not by Gary Halbert of Halbert Wealth Management, Jul 11, 2018

Don't Fear the Yield Curve Reaper by Liz Ann Sonders of Charles Schwab, Apr 24, 2018

A Flat Yield Curve is Not All Bad - Investment Grade Market Outlook by Eddy Vataru, Scott Ulaszek of Osterweis Capital Management, Jan 24, 2018

Why are market watchers and economists writing contrary articles? Two reasons: 1) most are in positions where they don't want to call a bear market, so they are naturally inclined to take a bullish stance, especially in light of the long bull markets in both stocks and bonds we have experienced, and 2) the Fed manipulated short-term rates so low while using long rates for financial stability that the signal of an inverted yield curve might not be as much of a predictor, it is merely a result of a confluence of Fed events and might not constitute an economic signal.

That brings us to the point of this commentary: The Fed's manipulations in the markets and financial system are widely acknowledged to be so large and ongoing that many are truly unsure about how well traditional economic signals or mileposts will work during this part of the business cycle.

Generally, market participants, analysts and economists try to gauge where we are in the business cycle by comparing growth rates, interest rates, securities movements, investor sentiment and money/trade flows to other episodes in history. Some of the more widely watched indicators (not in any particular order; it is hard to prioritize what will be a problem first) are:

Yield curves (US Treasury curve but also European and Asian governments and worldwide corporates, too)
The direction of short-term interest rates
Valuations measures in the stock market (Shiller CAPE (10-year P/E) ratio, e.g.)
Unemployment rate / Initial jobless claims
Direction of the Index of Leading Indicators
Level of housing starts
Inflation rates / money creation rates
Bond default rates/credit quality (especially junk bond default rates)

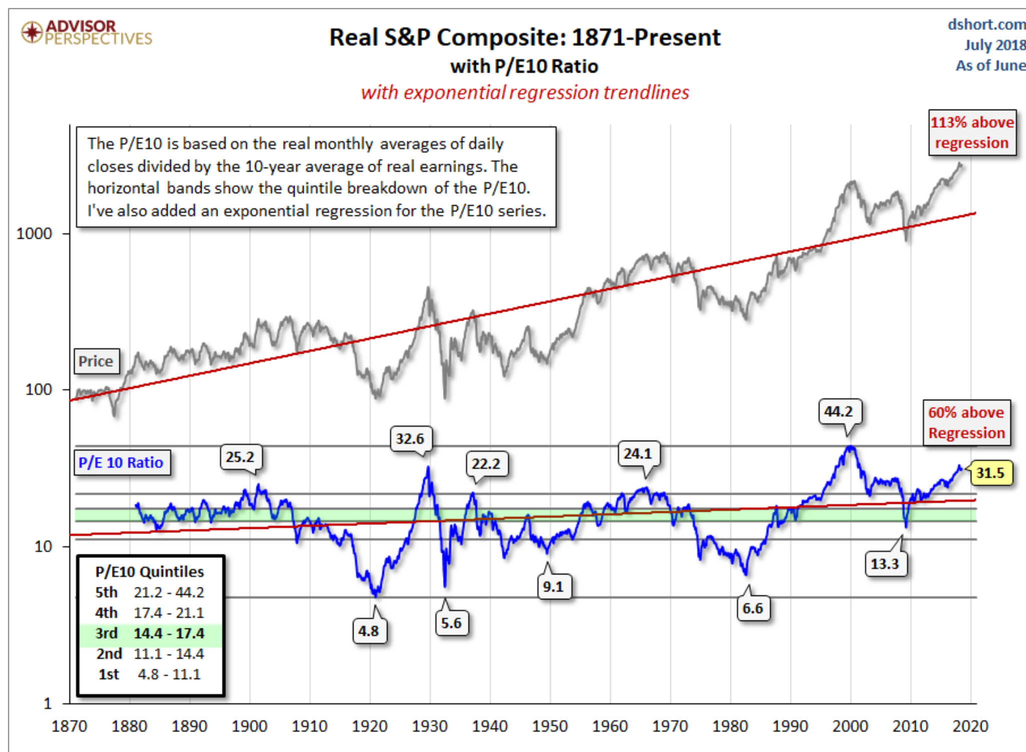
We believe central bank and governmental interference in capital markets and statistics have obscured several market signals, making interpreting "where we are" in the business and market cycles harder to discern. This is a problem because when the market has "mis-read" signals, and when real conditions are revealed, volatile adjustments will occur, making the relative calm of pre-2018 markets a distant memory.

Yield curve – We believe the yield curve should be a bigger concern. As stated above, many market participants are basically paid to be bullish, so their "advice" should be taken with a grain of salt because they may or may not be sincere when pontificating. Some analysts, like David Rosenburg, formerly of Merrill Lynch and now with Canadian firm Gluskin Sheff, are genuinely concerned. And why shouldn't we be concerned that long-term bonds, in a time of rising inflation, tariff uncertainties and 4%+ economic growth cannot move above 3.00% (on the 10-year) and 3.20% (on the 30-year), basically around one Fed Funds raise away from being flat? This should be a flashing yellow at least, if not changing to red. However, many economists are precluded from calling bad times ahead, so market

pundits are the only ones to pay attention to on this matter. This is most concerning because so many say they aren't concerned about a recession until the yield curve inverts. Well, here it comes. **Signal efficacy: Relevant Kanos concern level: Truly concerning**

<u>**Direction of short-term interest rates**</u> – The Fed has been raising the Fed Funds rate (short-term interest rates) since December 2015. Only now, with spot rates reaching 1.85% and 2-year Treasuries paying 2.65%, have interest rates started to reach even the high end of the "emergency low rate zone," meaning low rates are still attractive and stimulative. But at some point, rates will be high enough to cause interest expense problems for firms and individuals, affecting their financial situations and curbing their spending. The Fed has been as plain-spoken about this part of their policy as they have ever been. So far, high rates haven't affected things much, and most market participants are sanguine about rates at these levels; we are not concerned yet. **Signal efficacy: Relevant Kanos concern level: Not a big concern yet**

<u>**High Valuations**</u> – This has obviously been a concern of ours for years. There are several ways to measure valuations; one we think is the most "fair" is a longer-term measure that tends to average out large distortions. Thus, using a price/earnings ratio with a 10-year average for real earnings takes out some/most of the distortions. As seen in the chart below from Advisor Perspectives, a study Jill Mislinski updates monthly, using a PE-10 number with prices of the S&P 500, we are currently 113% above what an exponential regression to the mean would say is fair value [upper graph], or 60% above regression to the P/E 10 ratio [lower part of the graph]. Market pundits have claimed that at low interest rates like we have had for the last 10 years, these valuations are justified.



Our reaction to the low interest rates argument is: the 1930s also saw some very low interest rates (and tariffs and trade wars) and the P/E 10 dropped as low as 4.8 to 5.6 twice. Our markets are currently at 31.5, third only to "blow off" market tops of 1929 and 2000. **Signal efficacy: Relevant Kanos concern level: Truly concerning**

Unemployment rate – Unemployment is reported to be near historical lows, but unemployment was calculated in the past differently (under the newer methodology, more than 90 million Americans are not counted in the workforce). So, when participants cite the strength of the economy, they say the "U3" calculation, which is currently 4.0% unemployed. However, if you used the past methodology (used in the 1970s and 1980s), the unemployment number is 7.8% (the U6 calculation). This is an example of governmental obfuscation: politicians making something look better than it used to. We wouldn't be passionate about this number except that it is being used for policy decisions – do you think people will make different decisions if the unemployment rate is 4.0% versus 7.8%? Of course they will! There might be more job training, job fairs, placement centers established by the government, etc. And the Fed might not be as set on a course of rate tightening. So, we think the change in methodology shows a potential policy mistake as well as being wrong on a humanitarian basis. **Signal efficacy: Relevant Kanos concern level: Concerning**

Direction of the Index of Leading Indicators – Advances in the Index of Leading Indicators are usually considered a sign of continued economic strength. Only after three consecutive months of falling index levels do economists start to worry about economic weakness. So far, Leading Indicators haven't registered three months of losses. **Signal efficacy: Mildly relevant Kanos concern level: Unconcerned**

Levels of Housing Starts – Housing starts, when they fall consistently, are a more general indicator of economic strength and weakness. Lately, housing starts have roughly plateaued, yoyoing between more and fewer starts. Starts, however, have not stayed above 700,000 annually, far below the 2,000,000-reading seen at the heights of economic strength in the 1990s and mid-2000s. So, we are perplexed by the seemingly low peak number, but it fits with our theory of a lower peak of economic strength post-2008. **Signal efficacy: Mildly relevant Kanos concern level: Unconcerned**

Inflation Rate – Similar to the unemployment rate, the inflation rate calculation has been changed by governmental bureaus over the years. The most concerning thing about inflation measures is the distortions built into the numbers these days. First, the concept of an inflation measure is dependent on comparing subsequent prices on a basket of items. Lately, the methodology has been changed to substitute cheaper items (example: chicken for steak) as basket items become more expensive; isn't that systematically understating inflation? Also, the concept of excluding food and fuel from a "core" reading of inflation has been en vogue for the past couple of decades. This is stated to have been done because food and fuel are considered volatile, but economists have subsequently used the core rate to judge the absolute of inflation (virtually ignoring food and fuel). Doesn't using a measure that strips out volatility both give a too sterile and a possibly incorrect reading because food and fuel are used by everyone, thus judging inflation without these important elements included misstates true inflation, potentially in a significant manner? We believe it does, so we think that measuring inflation in these "politically correct" methods gives incorrect readings and leads to potential policy errors. **Signal efficacy: Very Relevant Kanos concern level: Concerned**

Money Creation Statistics – These measures are typically reported by the Fed, who gathers the info, reports them and uses them to make policy decisions. They are pivotal to understanding how much money is available to businesses, citizens and the economy; it shows the veritable "lifeblood" of the economy. The best-known measures include M1 (mostly currency and checking deposits) and M2 (the M1 balances plus time deposits). M3, a broader measure of money supply, was what was watched most closely by Fed Chairman Alan Greenspan in the 1990s/2000s, but the Fed discontinued reporting M3 in the mid-2000s under Chairman Ben Bernanke, at a time when M3 creation seemed to be excessive. We consider this obfuscation. M3 was a key measure and measuring it (the alleged reason they stopped reporting it) has got to be getting easier (with computer technology and the Fed's powers for bank regulation). Along the same lines, the Fed, until recently, reported the amount of Quantitative Tightening (foregone purchases of bonds as the Fed allows their balance sheet to shrink) weekly, but in the past few months, it has stopped reporting this number. We think both instances are examples of numbers that might embarrass the Fed at some point, so they have stopped reporting them to the public although they are still gathering the data. This is government secrecy at its worst. Thus, since we don't have all the data we used to, it is harder to make a judgement; however, we think the QT number is available through other channels, so we think we can find the number. The fact that they are hiding it and it could have a very definite affect on markets concerns us, more so, as it gets larger each quarter (currently $40 billion per quarter – not an insignificant amount of bonds to forego purchasing). **Signal efficacy: Very Relevant Kanos concern level: Concerned**

Bond Default Rates/Credit Quality – When the economy slows down, monitoring of how much and what kind of companies are defaulting on their debt can help judge how the economy will be affected. An example of this was in 2014 when oil prices dropped; it was judged that while energy companies experienced some serious stress and many energy bonds defaulted, the economy was strong enough and many companies were strengthened by lower expenses due to lower energy prices. Today, credit quality is near its lowest in recent memory because extremely low interest rates for the past ten years have incentivized low quality companies to borrow money. Yield-hungry investors have tolerated more risk in their portfolios at the same time in order to earn more interest. We are concerned that when the combination of higher interest rates and QT constrain liquidity enough, bond defaults will happen quickly as the next real refinancing wave starts in 2019. **Signal efficacy: Relevant, but not yet Kanos concern level: Truly concerning**

In summary, several indicators that help us to determine where we are in the cycle, and more importantly, when we might be able to expect trouble, are being ignored, downplayed or in some cases, obfuscated – and that concerns us. In some cases, governmental actions or decisions have lessened the usefulness of some indicators or obscured some formerly important reported numbers. In other cases, formerly important indicators that are starting to indicate reasons for economic concern are being dismissed by many financial commentators. We think many of these financial analysts are being less credible than normal due to their predisposition toward bullish interpretations, regardless of the actual condition of the indicators. In our minds, they are ignoring concerning data that indicates all is not well in an economy which by at least one measure (growth of Gross Domestic Product, as reported at 4.1% last Friday), is considered very healthy, almost certainly too much so. We are wary that the many of the

indicators enumerated above are signaling danger, and we are prepared with our current portfolio construction and our attentiveness to market action to react definitively when needed.

The Managers of Kanos Capital Management
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