KANOS
CAPITAL MANAGEMENT, LLC

Third Quarter 2018 Investor Letter

Portfolio Comments

The recent stock market turmoil has roiled portfolios across the spectrum including ours. We have been building your portfolio over time to prosper from prior conditions but also to survive and be preserved in environments like we have seen during October. We are reviewing our portfolios in the Kanos Quarterly Commentary section following our market analysis; flip to the back to get a detailed view with opinions and charts.

Market Analysis - Looking Forward

The US stock market has shown resilience for much of the year, especially when compared to international stock markets. The continued growth of the US economy, coupled with still-easy monetary conditions in the US and around much of the world, led to higher stock prices though the summer. However, rising interest rates have started to slow growth and tighten monetary conditions, which constrain corporate profit margins and growth rates. This "late stage behavior" of economic growth has started to impact corporate costs, revenue growth and, as a result, valuation multiples, leading to corrections in worldwide stock markets – including the US. Recent stock market turmoil surrounds third quarter earnings announcements and the accompanying corporate outlook for the fourth quarter and full year 2019. Earnings have been overwhelmingly positive, but growth and outlooks have been uneven, leading to share downdrafts all over the markets. We will present our forecasts for different sectors of the economy and financial markets in the following sections.

Economy

The US economy has been the engine of growth for the world for the last two years as President Trump's more business-oriented administration was recognized by markets to be much more positive than years past. Climbing economic activity culminated in two quarters of 3.5% real GDP growth as reduced regulation, trade negotiations aimed at improving US firms' competitiveness and legislation, headlined by corporate-oriented tax cuts in 2017, led to improved business conditions and strong US economic growth. However, as a long business recovery from the depths of 2008-2009 collide with a less accommodative Federal Reserve Open Market Committee (the Fed), the economy is starting to decelerate from its earlier torrid growth.

The Fed feels like it needs to keep restricting monetary policy for three main reasons:
1) controlling inflation (part of the Fed's mandate), which has trended up recently, driven notably by higher energy and food costs and rising labor costs, which we have not seen for many years,

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2) removing accommodative monetary policy due to the strength of the economy, which entails moving rates up to what is perceived as neutral (and also gives the Fed more room to lower rates when the next recession inevitably happens), and
3) dampening easy money driving financial markets to bubble-levels, which some of us would argue has already happened in some markets.

Their efforts include raising short-term interest rates, which leads to higher borrowing costs for all borrowers who use variable rates: credit card borrowers, borrowers using bank loans, governments (who issue lots of short-term debt which is more expensive to issue as rates rise), etc. Fed tightening also includes letting government bonds and mortgage bond holdings mature, which is the equivalent of selling bonds. The Fed had been a buyer of Treasuries and Agency Mortgage Debt for years until late last year; now they are effectively sellers, causing more pressure for borrowers/issuers who must incentivize non-Fed buyers to buy the debt formerly owned by the Fed. This double-tightening strategy by the Fed is untried and is starting to have its effects on the US economy.

Bottom line: the US economy is still expanding, and employment is still tight and growing, but storm clouds are forming, and there are plenty of signs of slowing already appearing.

Europe and China also see their economic growth slowing, which has been happening now all year and is evident as governments try to crank up some stimulus to reignite growth. European growth slowing is best evidenced by Italy proposing a large deficit for next year's budget which includes stimulus for growth. In addition, Germany is showing nearly flat economic growth and retail sales, moribund enough that the ruling CDU party has lost seats and most recently, their majority in the latest regional election. China is showing growth below the ruling party's 6.5% growth target for the first time in years, headlined by a build in inventories. Emerging market countries are suffering from inflation brought on by higher oil prices, higher interest rates and higher import prices caused by a strong US dollar.

Equities

The big conundrum is the US stock market; are we in a corrective downtrend or are we in the first stages of a bear market? There are arguments for both interpretations:

Corrective phase with more bull market to follow:

- There has been no "blow off top" phase (except in certain large cap technology stocks) that almost always happens in bubbles,
- Stock prices have followed economic and earnings both up and down; many recent drops in companies with earnings disappointments have made valuations more reasonable,
- The US economy is still quite strong and can have a "mid-cycle slowdown" that would pause the stock market but allow for a re-acceleration next year, and
- Corporate buybacks have waned lately with US stock markets at highs, but as many stocks have fallen and more than a few at 52-week lows, valuations make company shares more attractive to corporate CFOs and treasurers.

First stages of bear market with more to come:

- Valuations, even after some corrections, are still at near-record highs, meaning markets have much further to fall to re-gain "fair value". The Fed is getting more and more restrictive, and a restrictive Fed is usually the final spark that eventually leads to recessions and resultant bear markets,
- January 2018's ramp higher at a near-vertical rate represented the top (although a handful of large cap stocks have allowed indices to post slightly higher highs during the summer), and it could be called the "blow off top" many feel is missing, The surprising tax cuts that went into effect during 2018 allowed for an economic (and thus stock market) bump, and the lower tax on corporate cash repatriation allowed another big bump in corporate buybacks during this year,
- Many internal measures of the market and trends/trendlines have been broken during September/October, and these internal measures show "under the hood" deterioration which often leads to larger/longer-term corrections, and
- The complacency still evident in the US markets, combined with relatively little liquidation occurring, points toward a market much more vulnerable to more drastic down-moves than a wary market that can climb another "wall of worry" to new highs.

Experts are also split about where the market stands. Naturally, the cheerleaders on financial TV continue to spout the "merely a correction" and "what to buy now" narratives, with an endless parade of Wall Street "sell side" salespeople telling you what to buy. We try to follow a spectrum of analysts that we believe have told "both sides of the story" at various times in the past, giving us more confidence that their analysis is less biased, and they will call both "up markets" at appropriate times but also "down markets" when data becomes convincing. Unfortunately, most of these analysts are telling us to "batten down the hatches" and be defensive, convinced that this is a bear market. Most analysts tend to look at things for the short-term, so that is a difference of time frame, but it is still worrisome that so many different voices we have come to trust are negative.

Last note on US markets: midterm elections and geopolitics will have more of an effect on US markets now that the tailwind of central bank monetary stimulus has lessened (and reversed in the US). So far, these factors have not affected markets as much, but their effects on oil prices could lessen or aggravate inflation depending on how oil prices are affected. Inflation is back on the front burner of central bankers and financial analysts who use central bank decisions to help ascertain probably future policy.

Bottom line: the "jury is still out" because the major US stock markets have not broken the February 2018 lows. Thus, while we are continuing to adopt a defensive portfolio stance, we are keeping many of our "risk positions" that perform best in bull market conditions until we decide a major downtrend is confirmed. Most importantly, central bank liquidity injections for the last ten years have led to a "bubble of everything" that has affected value stocks least, even when compared to private equity and real estate. We firmly believe we have very attractive investment opportunities in public markets to build value in your portfolios, even during bear market conditions. We will be monitoring markets closely about whether to buy in when conditions are more attractive or to lighten positions that we judge less attractive for the future or to be at risk long-term.

European stock markets have shown no ambiguity; they have been weak as European economies have slowed and political turmoil has flared in Italy, where Italians plan to run a fiscal budget with a large deficit, in contravention to European Union laws. This showdown, similar to what Greece went through (and lost) a couple of years ago, pits the third largest European economy against Brussels bureaucrats; if Italy "wins" and is allowed to run a big deficit, this calls into further question the rule of the EU over each country – and the resultant uncertainty will continue to negatively affect the perception and trade situation of many European multinational companies. In addition, the continued difficult negotiations between the EU and UK over "Brexit"(and all the negotiating points for breakup that must be decided upon) has led to continued instability and thus downward pressure on both EU and UK stocks, bonds and currencies. We continue to avoid most European companies for these reasons.

Chinese stocks have fallen precipitously all year, as Chinese economic growth continues to slow and trade tensions with the rest of the world, most notably with the US, take a toll on Chinese trade. The resultant drop of the Chinese yuan has led to further selling of Chinese equities, including those ADRs traded in the US that had held up better than Chinese traded stocks for most of the year. We are also avoiding these stocks, as well as most other Asian stocks that are affected by these same conditions because we feel the valuation excesses outweigh the growth prospects of the companies, keeping them overvalued in our eyes.

Emerging markets have gone down for most of the year, dominated by Chinese stocks that make up a large weighting in EM indices. As stated above, we feel the strength of the US dollar and the falling growth of domestic Asian economies make the risk/reward for current investment in these shares unappetizing. The following chart of the iShares MSCI Emerging Markets Stock ETF (EEM) from FinViz.com shows the poor action year-to-date.

Currencies

Currencies have become even more important in financial markets because of the more powerful effects of a strong US dollar on international financial markets lately. The relative weakness of the US dollar from 2010-2014, combined with the Fed's quantitative easing and the resultant worldwide availability of dollars, led to historically high levels of US dollar borrowing by overseas governments and businesses, helping the world economy to slowly recover from the deep recession of 2008-2009. The recent slowing of world economic growth has led to many world currencies falling versus the dollar, especially emerging markets ("EM") currencies. Having dollar-denominated debt that must be paid back (or at least paying interest and any amortization) with proceeds in EM currencies puts major brakes on economic growth when the dollar rises and those financing costs rise. The situation won't end anytime soon as the Fed continues to raise short-term rates to cool US economic growth and inflation; higher (and rising) interest rates attract even more capital to dollar-denominated investments, and Jerome Powell, the Chairman of the Fed's Open Market Committee, has said that they are "nowhere near" the neutral short-term interest rate (where real rates equal the rate of inflation), leading most market watchers to conclude the Fed will continue to raise rates.

Thus, the US dollar has risen as the US economy continues to be the best engine of economic growth in the world, combined with the opinion that the US is better able to benefit from the tariffs being imposed on trade by the Trump administration as the US negotiates better trade terms on a number of its trade pacts. Notably, the US is considered to be hurt less than China in the ongoing trade/tariff disputes between the two countries, leading to the Chinese yuan falling to lows not seen in three years. A stronger dollar against the yuan (and almost all other emerging markets currencies) has led investors to move funds out of emerging economies to better perceived investments in dollars, pushing down the value of those currencies. Lower currencies and funds outflows have led to a further slowing of these economies due to funding constraints and increased financing costs. This has been a major contributor to emerging countries' equity bear markets during 2018. Europe and Japan have not been spared as the Europeans/Japanese sell a lot of exports to emerging economies; these exports flows have waned, leading to lower economic activity in Europe and Japan and to falling stock markets.

Our thought is that until the Fed decides that rate rises are hurting too many things (most importantly, the US economy, but also US borrowers in general) there could be more turmoil in financial markets, and to a lesser extent, volatile economic conditions around the world caused by a strong dollar (the Fed has said numerous times that they DO NOT consider world economic conditions, in spite of the fact that the dollar is still the reference currency with the most important interest rates worldwide).

There is growing thought in financial circles that after the Fed raises rates in December (the raise has been widely telegraphed and current Fed Funds futures put the chance of the raise at 60-80%), the Fed might then tone down the rhetoric of continued rate increases, adopting a more "wait to see" or "data dependent" interest rate stance. If so, we believe the dollar will immediately start weakening as people see the US financial markets as less attractive, looking for better yields in other currency regimes. Such an "about-face" by the Fed would probably help most asset prices, including stocks, as a more dovish Fed would shift thoughts to lower interest rates, benefitting stocks, commodities and other risk assets.

The yen and euro were weak during the third quarter of 2018 and have continued that weakness into October, as weak financial market results, which started in the US, have spread to the rest of the world. We believe the yen may reverse and rise during the fourth quarter or early 2019 as financial market turmoil could lead to Japanese capital repatriation, leading to yen re-buying by Japanese investors. In addition, the Bank of Japan ("BOJ") has been uber-easy in monetary policy for decades; they have recently been perceived as not stimulating "as much" – if this persists, the perception of even a little tighter policy could lead to yen buying for safety, driving the yen higher. Note: the BOJ is virtually out of ideas for monetary stimulus, so stay tuned if they decide to get even easier; tactics could include currency handed out to all Japanese (by the government but completely financed by BOJ money printing) or increased Japanese stock market purchases or even manufactured goods purchases (all with newly printed yen).

The ECB is in a completely different situation. Having painted themselves in a corner of finishing up their quantitative easing program in 2018 (most probably because they have run out of German bonds to buy, which must be bought in proportion to all other European bonds with respect to the size of the countries' economies), they will have to come up with a new way of trying to manage monetary policy. Don't forget that 2-year bonds in the US yield around 2.85%. In the Eurozone YOU MUST PAY -0.174% in Spain, -0.418% in France and -0.613% in Germany currently. Of course, these unbelievable negative rates, where the lender must pay the borrower to take their money for two years, is seemingly completely dependent on the ECB buying these bonds at elevated prices. Since these bond yields are current as of late October, one must surmise that the market does not believe the ECB will stop its bond buying – it will probably be forced to switch to selective buying, much to the consternation of the "strict constitutionalists" who will continue to insist on proportional buys. This may be a very large source of instability going forward.

The emerging markets currency arena seems like it will have to go through continued pain until a let-up in the dollar helps take some of the pressure off. However, for some countries, the damage may be considerable, with several projects/companies declaring bankruptcy or needing some bailout by their lenders. If it gets too big, it might lead to some government bailouts; however, those would only happen in 2019 at the earliest. A strong dollar will probably just continue to put pressure on dollar debts, limiting growth as dollar financing costs must be paid, and stealing economic "fuel" from other sources.

Probably the most interesting currency situations are in Australia and Canada, where housing bubbles look to be deflating at the same time inflation leads their central banks to raise short-term rates. The central bankers are caught between inflationary forces (which are supposed to be countered by even higher rates) and deflationary forces of falling housing prices and shrinking real estate and financing activity. The currencies and banks in each country have been relatively strong so far, but October has led to some sudden weakness, possibly showing the initial effects of the bubbles deflating. It seems like time has run out on these non-US dollar currencies and they will fall as housing activity continues to weaken.

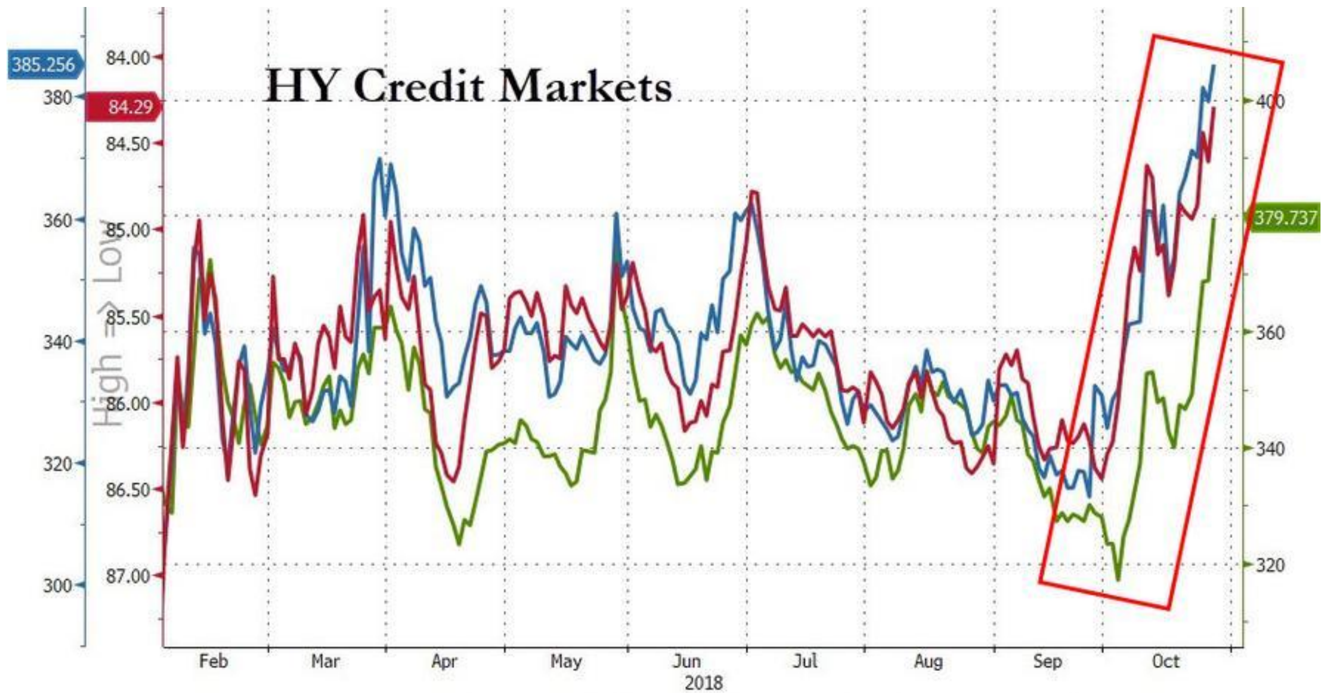
Bonds

The still hawkish Fed will almost certainly raise rates in December 2018 and is still projecting to raise rates 2-3 times in 2019 before pausing. The markets in US interest rates have priced in only two rate rises for 2019, but that could also shrink if US financial markets weaken further. With current Fed Funds rates at 2.00-2.25% and December and two other rate rises looking likely today, that would still leave short-term rates below 3.00%, which many believe the Fed currently thinks of as the "neutral rate" where monetary policy is neither accommodative nor restrictive. We believe the current volatility in financial markets will not be short lived, so we are leaning toward short-term interest rates rising little from these levels.

Long-term interest rates, as represented by the 10-year US Treasury, peaked recently around 3.26%, but since have fallen toward 3.10%. We believe that the potential slowing of the US economy could cause investors to reconsider adding bonds in their portfolios, highlighting a new rising phase for bonds and lower long-term yields. We feel this will be true of Treasuries and high-quality bonds with covenant protections and low leverage. Treasuries and government bonds of highly rated European and Scandinavian countries seem to be the sovereign bonds which will be in demand.

A large percentage of corporate bonds are now really just junk bonds, due to a large majority of "investment grade" bonds being rated BBB or BBB-, the dividing line between investment-grade and junk. This means bond investors will have to be especially vigilant to try to understand the balance between money looking for fixed income investment and the failure of businesses due to their poor/failing business model and/or their financing costs (for example, Sears had to declare bankruptcy this month as its inability to generate enough sales and its huge interest costs consumed the shrinking company).

We are concerned about bond investors getting spooked in the high yield markets when credit quality, which has not been as much of a concern due to the ongoing liquidity provided by yield-hungry investors, becomes an issue, and bond owners "head for the door." High yield spreads, the amount junk bonds are quoted over the equivalent Treasury yields, have been low and stable recently, showing market complacency So, it is an immediate concern when we see the spread increasing rapidly, which is shown in the following chart from Zerohedge's 10/26/2018 Market Recap titled "Global Bloodbath: World Stocks Puke Over $8 Trillion As US Markets Collapse." As the chart below shows in the red box on the right side, spreads had been reaching toward year-to-date lows when they rapidly reversed and rose to new highs, coinciding with trade/tariff angst in financial markets and the resultant weakness in US equity markets. This shows a "skittishness" in the markets that cause elevated junk bond angst build as slowdown concerns start to bubble up into financial markets, as we've seen during October.



Thus, we will try to avoid longer-term corporate debt, sticking to the highest rated governments and corporates we can manage, while taking more risk in short-term debt, where risk can be better understood about borrowers and the risks surrounding repayment.

Energy

Energy has been extremely important in the inflation narrative during 2018, with West Texas Intermediate (WTI) Crude Oil rising from the $60s/bbl in January to the high $70s/bbl in September as geopolitical drama was heaped on top of supply constraints. However, during October, falling demand concerns have entered the energy debate, accompanied by falling geopolitical concerns (Iran sanctions not sealing off all supplies, Saudi Arabia promising to provide all supplies removed by sanctions, Russia negotiating to provide more supplies, etc.). These factors have served to push supply and demand more into balance, leading to falling oil prices virtually all of October, stabilizing in the mid-$60s/bbl as we write. We think that the turmoil in financial markets will affect the outlook for oil (due to concern about demand destruction), pushing prices down as low as the high $50s per barrel. However, we also think supply concerns are not unfounded as emerging markets producers find it expensive to pay dollars to continue to drill developmental as well as exploratory wells. If producers don't keep up at least their "maintenance cap-ex" (i.e. their developmental drilling to keep up current production levels), supply will not be maintained, especially in light of the continued turmoil in Venezuela and Libya. The real question is whether demand will be impacted if financial markets continue to correct; we believe this will come in fits-and-starts, having a see-saw effect on prices but not driving them much lower than $60/bbl. If not, we see crude prices in the $60s and $70s/bbl during the fourth quarter.

In truth, we should be talking about both Brent and WTI crudes; Brent crude is the de facto worldwide crude because it trades in an "unfettered" manner, i.e. Brent, sourced off the UK/Norway, can be delivered to any coastal country in the world. WTI, with its delivery point in Cushing, Oklahoma, trades at a discount because pipeline constraints don't allow all the crude at Cushing to be transported south to the Gulf Coast and exported (and some supply basins, most famously the Permian Basin, trade at a discount to Cushing because of the lack of transportation space to get crude from west Texas up to Cushing). WTI currently trades at a $10/bbl discount to Brent because of these constraints; so, our above explanation is more correctly talking about Brent prices at a $10 premium to WTI. However, the arguments apply to the whole crude complex, so we reference WTI prices because they are more relevant to the US and Texas economies.

Natural gas prices have shown strength through September and have maintained that strength through much of October on the back of earlier cool weather, supply constraints caused by late season storms and more promising fundamental and technical factors. We continue to monitor the natgas complex, but we still believe that the direction of winter prices will be set by the supply/demand balance set during November, when continued early cold could send prices up for the rest of the winter, but moderating cold could push prices down under $3/MMBtu again.

Commodities/Precious Metals

The precious metals were virtually ignored during the third quarter as more growth-oriented sectors took center stage. During October, as financial markets became more volatile and inflation started to exceed central banks' targets, investors have started to allocate more capital to the precious metals complex.

Gold and silver hit multi-decade lows in a number of positioning and sentiment measures in September/October, setting the stage for rebounds in metals prices and associated mining companies. These attractive fundamentals for precious metals and the multi-decade low valuations for many mining firms lead us to continue to have a meaningful allocation of your capital to this sector.

Kanos Quarterly Commentary

Risk and Reward

In this commentary, we will concentrate on where we see risk and where we see opportunity. We are going to have a number of charts and graphs for visualization purposes. I hope you find them instructive and interesting. Our macro process starts with sector analysis, moves to financial analysis of attractive companies in selected sectors and culminates by looking at charts/technicals. We also examine charts on a daily basis to help us visualize where markets have been and for idea generation for

new investments (or to further examine to sell if charts are deteriorating). So, as you go through these charts, remember this is only a part of our process but a good visual tool we use frequently.

The bull market that started in 2009 on the back of historically low interest rates, a deeply depressed economy due to the near collapse of the banking system and a deep correction in housing is widely agreed to be in its late stages. Late stages of bull markets typically allow some excesses to occur while excesses already in the system often fall apart, helping expose some fragilities that were not earlier evident.

We have invested your portfolio in investments that we think will hold up (or in some cases benefit) in the face of a rotation away from momentum-dominated growth investing that characterized the last few years in world stock markets. US stock markets, underpinned by a still-growing US economy, have continued to advance during 2018 (in contrast to most world stock markets) but some sectors and stocks are showing more risk than others.

Note: before we start reviewing the charts: we believe we are still in the bull market, but there are several charts that show prices "on the edge" of breaking down, which could indicate a trend change into a bearish or down phase. Many people have studied stock prices by how they respond in the four-year "Presidential Cycle", and typically, the second year (which we are in) underperforms and then next year, the third year, is the best performance of the four-year cycle. This year has been a little strange because after the February/March correction, we have seen an "up" phase almost exclusively, instead of a choppy market before the third year of the cycle starts. Also, July-September are seasonally typically weaker times for stock markets, but this year, there was mostly strength during that time. While stock prices don't always act like they have in the past, stock analysts, including us, look at these cycles as a starting point for where stock market prices might head, but are also influenced by economic, political, monetary and behavioral factors unique to the time period we are examining.

We are using charts from Financial Visualizations (www.finviz.com) because they show year-to-date (YTD) charts with some trendlines applied to help us see (at least) one interpretation of how the stock or index is trending.

We have avoided investing in the large indices because we were worried about the high valuations of some groups of large cap stocks. We are first showing charts of the major indices to see where the markets in the US stand as a whole. We have sidestepped some of the damage you'll see on the next few charts by overweighting a number of sectors and avoiding others.

Here is a year-to-date chart of the S&P 500 ETF (SPY), which contains five hundred of the largest US-domiciled publicly-traded stocks:

You can see the big correction of early February, the re-test of the lows in March/April, the uptrend afterward and the latest correction on the right of the graph. The S&P stayed inside its upward-sloping "channel," meaning it had not suffered concerning "technical damage" by falling out of the bottom of the channel until recently. Now, it looks like it will test the February and April lows; as long as it does not break them, we would anticipate a climb back toward the highs during 2019. If the lows are violated, we are most probably in a bear market.

Contrast the above with the Nasdaq-100 ETF (QQQ), which contains the hundred largest stocks traded on the Nasdaq. The Nasdaq has outperformed every other major index in the world during 2018, but we see some "internal damage" that has occurred in the latest down move.

The following chart of the Russell 2000 ETF (IWM) represents the smallest 2000 of the largest 3000 stocks in the US. This is the proxy for small stocks, and they have been the weakest of the stock groups all year. They have fallen to the lows from February, indicating the most "technical damage" of US stock groups. This could be signaling a trend change, i.e. a downward phase for prices, if it heads lower. We should know whether it will do so fairly soon. We have stuck to mostly large cap stocks to try to avoid the damage shown below.

US markets have far outperformed other markets around the world, especially when factored in US dollar terms (the US dollar has been strong, adding to returns of foreign investments here in the US). In contrast to the S&P 500's approximately 0% gain YTD, these foreign stock markets are worse (as of October 19, 2018): Stoxx Europe 500 (large cap European stocks) -7.2%, Germany's DAX -10.6%, France's CAC-40 -4.3%, Britain's FTSE-100 -8.3%, China's Shanghai Composite -22.9%, Japan's Nikkei -1.0%, Hong Kong's Hang Seng -14.6%, Mexico's IPC -3.9% and Canada's TSX Composite -4.6%.

Below is a chart of Vanguard's FTSE Developed Markets ETF (VEA) that holds stocks from Switzerland, the UK, South Korea, France, Japan and other developed markets. It seems to have peaked in January and has been in a firm downtrend ever since, lately breaking the lower channel which could indicate further selling. **This is a scary chart and one reason why we have avoided European and Asian stocks.**

The next chart is of the iShares MSCI Emerging Markets ETF (EEM), dominated by Chinese stocks. It is just as bad as the developed world (ex US) ETF shown above, which is surprising in light of so many analysts touting investments in Emerging Markets in general, and China specifically, for their future growth prospects. The stocks are NOT confirming the view that the professed growth is a good investment right now, and while there are bargains galore in this ETF, **we have avoided taking positions in these stocks, to the benefit of our portfolios.**

Looking at the above charts shows why we have confined most of our investing to US companies, although many have large international operations, and some, like large resources companies, have properties all over the world. We will get to those at the end of the commentary.

Despite the appearance of the S&P 500 and Nasdaq charts above, there are several sectors/stocks in the US that represent large parts of the economy that we believe have a lot of risk. We will highlight some of the sectors by using large representative stocks in that sector to show the riskiness.

Because of their outperformance, we think there are a number of large cap technology stocks that are very risky at this point. However, most analysts are still saying that they can continue to grow and thus outperform, as they have in the past; we disagree and put forward these graphs. Again, we have avoided these stocks, initially missing out on the upside but not suffering the damage they are showing now.

The first highflier is Nvidia (NVDA) – a specialty semiconductor chip maker that designs and manufactures high-end chips for workstations, gaming, crypto-mining and other technologically complex tasks. While FinViz still indicates the stock was in an uptrend, the stock shows a huge drop from its late September peak, down more than 20% during the month, and more importantly, breaking the channel that was intact even during the February mini-crash. The chart action shows that investors were not willing to buy NVDA enough to keep it "in the channel." Buying demand has only come in at much lower levels, meaning there is less and less enthusiasm at even "bargain prices." Nvidia holders are in trouble, and this extreme price action is a pretty good "tell".

Next is Facebook (FB); as many know, Facebook has been in the crosshairs of government regulators due to multiple security breaches, hosting less-than-savory groups online, probably-illegal sharing of client information, etc., etc., etc. As government probes and security problems mounted, FB announced that in addition to these problems, their user growth had slowed down significantly. Their increased expenses for security and compliance (announced in July) along with reduced growth is obvious in the middle of the chart. The stock has not recovered, and its purported growth vehicles, Instagram and WhatsApp, have reported security problems lately, adding to FB's woes. Finally, the entrepreneurs who developed Instagram, WhatsApp and VR Oculus, all of whom worked for Facebook after their firms were bought by FB, have now all left due to their criticism of management and the deteriorating culture of the firm. The stock has now broken down past the lows following the reports of the first governmental probe of the firm; thus, Facebook and its holders also looks to be in trouble.

In addition to tech shares, three other segments of the economy that employ hundreds of thousands of Americans are showing some serious stress. While we are attracted to these three value sectors, we have only made small forays into these investments that we subsequently exited when price action (failures to rise) encouraged us to sell.

The automobile industry, which has been producing at high levels (17 million cars/year rate) and should be getting a bump from new car sales after Hurricanes Florence and Michael instead looks very weak. Ford and General Motors charts are similar, but below we show the GM chart that has virtually plummeted since hitting an interim high in mid-June on good news about electric car development. The hurricanes that should have helped sales in August and September are only small blips on an ugly chart. Both stocks are near yearly lows and Ford is at a multi-decade low. This chart shows a lot of risk in the auto industry right now, although recent quarterly results have led to small rebounds.

Next is the finance industry, best represented by the big banks. The king of the banks in the US is JP Morgan Chase (JPM), which is not only the biggest bank but also the most profitable. Looking at the chart below of JPM, it has not been able to hit new highs this fall despite higher interest rates and an improved economy that should have provided the best loan growth in the last 10+ years. However, the chart shows the stock settling back to the lows of the year when banks should be thriving.

Bank of New York Mellon (BK) shows how poorly many other banks have performed recently. **We have avoided these types of investments, despite analyst predictions of high earnings and "low risk" due to our hypothesis that loan demand is lower than projected after ten years of historically low interest rates.**

The homebuilding industry makes up almost 4% of GDP in the US, but the homebuilders' stocks have performed very poorly, indicating a lot of risk in the stocks. Below is the chart of D.H. Horton Inc.

(DHI), one of the biggest of the publicly-traded companies in the business. We have invested in some homebuilders but exited the positions due to poor price action.

The above charts all show recent poor performance with imminent risks to the downside. But there are other situations where sector business opportunities are more promising, valuations are more reasonable, and the charts are more promising. Next are some of the situations that we own, and these charts look much more attractive.

We own pharmaceutical giant Merck & Co, (MRK), which has performed very well with its broad assortment of drugs, headlined by their blockbuster cancer drug Keytruda. It has a reasonable valuation, growing product pipeline with its expanding cancer-treatment suite of drugs, pays a 2.65% dividend and has just hit another 52-week high:

We like utility-like businesses that have growth and barriers to entry; Verizon (VZ) fits this bill with growth through its online/internet sector (having bought the rest of its Verizon Wireless joint venture, AOL and Yahoo for reasonable prices over the years, as opposed to rival AT&T's very expensive delivery systems and content buying spree of DirecTV and TimeWarner). The market has recognized this measured acquisition strategy coupled with its organic growth to produce a stock market winner (hitting new multi-year highs this month):

Another sector we like, even with rising short-term interest rates, are US utilities. They are good sources of income and provide a certain amount of protection against inflation. The charts have been very constructive; our investors own the SPDR Select Sector Utilities ETF (XLU), shown below, which holds a cross-section of US utilities.

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Not all of our picks look as good technically. We are still bullish on the defense industry, as represented here by Lockheed Martin (LMT) below. The defense contractors were riding high but corrected during the summer. After regaining their upward momentum this fall, the October correction coupled with uncertainty around the Khashoggi affair in Saudi Arabia that could affect a number of arms sales to the Saudis have hurt US defense contractor stock prices, as seen below. The defense stocks, like Lockheed and Raytheon (another stock we own), have been consistent growers at reasonable valuations and with attractive yields, so they have been included in lots of passively managed ETFs that sold during both the February-April and September-October stocks swoons. We still think there is multi-year growth in the industry as older and older weapons systems both domestically and internationally must be replaced over the next few years, helped by simmering geopolitical tensions around the globe. Valuations are still reasonable, and we maintain our positions in these attractive stocks, in spite of some extreme price volatility.

Our mortgage REITs, which are real estate investment trusts that invest in mortgages on residential and some commercial real estate have suffered some with rising rates. Annaly (NLY), the largest of the mortgage REITs, is owned in most of our portfolios, and they issued new shares (diluting shareholders in the short run but most probably building value in the long run), which hurt the stock right when long-term rates rose above recent highs, sending selling through the fixed income world, including this stock (just like bonds, as rates rise, the mortgages held in these REITs fall in value). However, the mortgage REITs are somewhat "protected" by having good cash yields. Annaly has a 12.2% yield which makes the drop shown below less painful. We plan to stay in these stocks as we believe interest rates won't rise appreciably from the recent range we've seen. If rates were to start to "run away" to the upside, we might trim this position and look to build it back when rate moves have settled into a new range.

We have been bullish on oil and energy stocks since the oil went into backwardation (when present prices are higher than future prices, indicating strong demand). Despite variation in supply due to production increases as well as interruptions in Libya, Iran, etc., demand has stayed strong so far. Prices, while varying quite a bit in the channel, have just pushed below it, as indicated by the US Oil Fund ETF (USO) below, but are still higher than lows from earlier in the year. We haven't invested in oil itself, we have instead invested in less risky integrated oil companies, which have chemical and refining segments to offset their exploration and production segments, which are dependent on oil prices

The energy companies in which we have invested have solid financials, good prospects and a formerly good chart, like ExxonMobil (XOM) below. Recently, it has fallen below the channel, which we expect is just temporary.

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Finally, our gold miners had a rough late summer swoon when gold followed the Chinese yuan down in value. However, since the middle of September, they have bottomed, as shown by a classic bottoming pattern known as a "reverse head and shoulders" pattern. As shown in the chart below of the Van Eck Vectors Gold Miner ETF (GDX), the price set a low in mid-August, then rallied but set a "lower low" in early September, after which it rallied. The final test of the lows only got down to the level of the first low, showing growing strength. Now the ETF has rallied above the whole bottoming structure and is consolidating before getting ready to move higher, toward the $21 level where it traded during the summer. As stated above, this is a classic and oft-repeated cycle of bottoming, giving us a lot of confidence in having our positions move back toward profitability.

I hope our visual tour through some of the indices, some trouble spots in the US markets, and some looks at how some of our positions look technically help each investor get a feel for how much risk is in

the markets and how we are trying to pick long-term holdings with good fundamentals that also exhibit good technical patterns. The visual aspect of charting technicals makes it an appealing tool in our toolbox of statistical, valuation, behavioral and sentiment-based tools we use to evaluate potential and current holdings to try to gain attractive rewards while trying to minimize risk in the medium- to long-term.

The Managers of Kanos Capital Management
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