KANOS
CAPITAL MANAGEMENT, LLC

Fourth Quarter 2018 Investor Letter

Portfolio Comments

Despite the turmoil seen during February-March and then again in October-December, we believe we are well-equipped to guide your portfolios through financial markets in flux. Our concentration on value, coupled with our daily review of financial markets and technical factors, have allowed us to limit damage in your portfolios while preserving upside in promising companies and playing defense in other sectors. We have preserved upside positions because we think there is a good chance the market continues its rebound in 2019; however, we are keeping a defensive stance that will preserve your wealth because prior markets have shown there will probably be more declines over the next couple of years. Thus, we feel we are well aware of both the positives and negatives affecting the current market, and we have a portfolio that will benefit in a number of scenarios, with some positions that benefit during rough times and owning numerous income-producing assets to earn all-important dividends/interest/ distributions which will bolster returns.

Year in Review

We believe the events of the last quarter and their effects on yearly results are worth a quick discussion. After a huge rollercoaster ride in January (up) and February-March (back down), the US equity markets rose through September, with some indices reaching marginal new highs. However, weakening overseas economies, a more hawkish Fed, the resultant stronger US dollar and demand/profit deceleration in US technology all led to a re-rating of equity multiples, leading to fourth quarter losses in most US equities and corporate bonds, as well as overseas markets and currencies. We would just like to recap these to emphasize the losses that occurred which has now changed the character of financial markets worldwide.

US equities, which had been up +10.1% through September, ended down -6.24% (4.94% with dividends included) for the year. Technology, the star of the upside earlier this year turned a +20.6% year-to-date return through September into a -0.3% return for the year after a miserable fourth quarter. Other poor performing sectors for the year included Financials (-13.1%), Materials (-14.7), Industrials (-13.3%) and Energy (-18.1%), all returns with dividends included. Winning sectors were Healthcare (+6.4%), Utilities (+4.1%), and Consumer Discretionary (+0.8%) where the gain was completely attributable to Amazon.

US Bonds were mixed: Treasuries, in spite of a mid-year spike in longer-term yields, ended up for the year, with the benchmark 10-year returning 0.26%. Corporate bonds fell for the year, as rate hikes and credit concerns pushed down prices (and pushed up yields); the return for the benchmark iShares Investment Grade bond ETF (LQD) was a shocking -7.2%, with more risky high-yield bonds slightly outperforming: the iShares High Yield bond ETF (HYG) returned -7.1%, although the other large high-

yield ETF, SPDR Bloomberg HY ETF (JNK) lost -8.5% for the year. International bonds performed in-line or more poorly than their US counterparts.

The real carnage occurred in overseas markets; developed and emerging markets equities and currencies showed heavy losses all year, cumulating with these yearly results: China's Shanghai Composite lost -24.6%, Germany's DAX lost -18.3%, South Korea's Kopsi lost -17.3% and Italy's FTSE-MIB lost -16.2%. Currency losses were even worse: the Argentine peso lost -50.8%, Turkish lira -28.3%, Russian ruble -16.7% and the Brazilian real -14.7%. Winners were few and far between, but Brazil's Bovespa equities rose +15.0% after Bolsonaro's victory in their presidential election and India's Bombay Sensex was up +5.9%, as was the Japanese yen (+2.8%).

The worldwide financial turmoil resulted in the US dollar rising 4.3% for the year. Gold, despite being down earlier in the year due to the higher US dollar, recovered strongly during the fourth quarter to lose only-1.8% (as measured by the SPDR Gold Trust ETF GLD). Oil was the big loser for the year with a disastrous fourth quarter drop, ending down -24.8% for the year with US RBOB gasoline down -26.4%.

All-in-all, it was a poor year for financial assets worldwide, ruined by a horrible fourth quarter where all the fears from years past started to be realized, and prices reacted. As relayed above, we believe we continue to have a good handle on events and have been anticipating trouble, so we believe we will steer your portfolios carefully to preserve upside while limiting downside through this volatile period.

Market Analysis - Looking Forward

Last quarter, we were writing after large-cap equity indices hit incremental new highs in September and then slumped during the first part of October. Little did we know that a combination of a tighter Fed, slowing growth, escalating trade tensions and high valuations would combine during the holidays to produce the worst December loss since 1931 (at the depths of the Great Depression).

Things have changed somewhat since then: most notably the Fed. After what can only be described as a hawkish diatribe in early October, Fed Chairman Powell started backing off his tightening bias, first suggesting that rate hikes may only occur if the data dictates their need. Then, on a panel of current and ex-Fed Chairs, he suggested that QT was no longer "on autopilot" and that the FOMC would examine how best to proceed. Finally, at the Fed's January meeting, the Fed announced that further rate hikes would only occur if economic data mandated more tightening, and that the pace of QT was no longer "on autopilot." These changes in stances were being demanded by the market but were widely expected to continue to be ignored by Powell's Fed, which has, until now, shown an unwavering drive for higher rates and a smaller balance sheet. These changes in rhetoric, while not yet put into practice (the balance sheet is still supposed to be running off at the $50 billion rate and rate hikes are still possible by the Fed), have changed one main impediment to further advances in financial markets. The "snap-back" rally that started at the end of December has proven to "have legs" with the cheer of an easier Fed bubbling through markets.

However, the part of the picture that hasn't changed is the slowing economic growth around the world, including in the United States. We detail more below, but several economic reports have shown slowing growth, and the beginning of corporate earnings season has shown companies with flattening profit growth (after large profit growth earlier in 2018).

Thus, we have a slowing economy but with a Fed finally paying attention. The drop in markets has alleviated the historically high stock valuations somewhat, but without a clear engine of growth, stock markets are poised to have an up-and-down period. The Kanos team has extensive experience in managing investments successfully through periods of turmoil, so we feel well prepared and positioned for the year ahead.

Economy

As introduced above, we feel world economies are slowing, pulling down confidence and stock markets with them. The US economy, the engine of growth for the world for the last two years due to President Trump's more business-oriented policies, seems to have passed its growth peak for this cycle. While we don't have many government statistics during January (due to the government shutdown), we have Fed and private data coming out. The Purchasing Managers survey (PMI) / Institute for Supply Management (ISM) surveys have shown distinct deceleration toward 50 (neutral) after being over 60 earlier in 2018. Housing starts and existing home sales have both dropped significantly in the past couple of months, due to higher interest rates and rising unaffordability (higher prices). Auto sales, while still at relatively high levels, appear to have peaked and have been dropping for the past few months. Reinforcing these trends are the poor performance of industrial, homebuilding and auto stocks during late 2018. These three sectors of the economy, which employ large amounts of workers and represent a large part of US manufacturing, show the growing weakness. The US service sectors, which have their own PMI/ISM surveys, also have shown deceleration, meaning the service industries are not holding up as well as they have in the past. There is still growth, but the growth is slowing down.

Bottom line: the US economy is growing slowly (not yet in recession), and employment appears to still be growing (although it is a lagging indicator), but warning flags abound and financial markets have taken notice, with stock prices down from highs and interest rates having retreated from 2018 highs.

International growth slowing is even more apparent. China has shown the lowest growth in several years and has implemented both monetary and banking changes to spur growth. Chinese GDP has slowed, and exports growth is nearly flat, so it is apparent that China is feeling less robust. Throw in the trade disputes and tariff threats with the US, and people are starting to worry about China. The other Asian manufacturing-oriented economies (Japan, South Korea, etc.) have also seen their export growth slow, with Japan's machine tool exports, long a bellwether indicator for industrial growth, showing recent weakness, also putting into question Japan's further growth and whether recession looms.

Germany, Europe's engine of growth, has already shown a quarter of negative economic growth, pointing to imminent recession in Europe's largest economy. The ZEW survey (Germany's main confidence survey) is registering recessionary levels, as is slowing export growth, the lifeblood of German manufacturing. Germany is not alone in showing signs of slowing; Italy just this past week reported

another quarter of negative GDP growth, signaling at least a mild recession. Spain, which showed nice growth earlier in 2018, has recently showed falling inflation and decreased demand, reiterating economic deceleration evident around Europe. The UK, in the throes of uncertainty over a supposedly-imminent Brexit, has also seen its economy and consumer confidence slips.

Emerging market economies have not impacted world economies and markets as much as earlier in the year. The weakness caused by a strong US dollar earlier in the year has not dissipated much, and EM stock markets, one indicator of economic growth prospects, while outperforming developed market stocks during the fourth quarter, have barely recovered from their long fall during 2018.

Equities

Last quarter, we asked: In the US stock market, are we in a corrective downtrend, or are we in the first stages of a bear market? Further price action in October, November and especially December show us that it was a bear market, as virtually all stock market indices broke down technically below levels that were considered support.

Now, with a large recovery in stock prices from the bottom seen on December 24th, we still face the same conundrum: was that the bear market or is their more pain to come?

We are preparing for bumpier markets because of the "late cycle" nature of the economy and thus, corporate profits. The slowing of the US economy has impacted some industries already, but we think that falling confidence surveys, which have until late 2018 been rising, will be a good indicator for whether consumers will continue to spend. With consumer debt levels at cyclical highs, it seems like spending will have a harder time rising. And we must have rising spending to have revenue growth, which is the key to sustainable corporate profit growth. So far, profit growth for S&P 500 companies reporting profits in 2019 has "beaten expectations" but has been disappointing after the extraordinary profit growth during much of 2018. We believe investors are giving companies "the benefit of the doubt" this quarter, where companies that have not disappointed have been rewarded with higher stock prices, even though results didn't justify the stock advances seen (meaning multiples expanded). We are curious to see where future growth will appear; the market is pricing in continued improvement of earnings, which were given a boost when the Fed puts its rate hikes on hold. There is certainly room for multiple expansion in many of the beaten-up cyclical stocks, which have suffered from depressed earnings during the slow-growth, post-recession period after 2009. We are optimistic and have portfolios to reap the benefits of cyclical profit rebounds. We are less sure of the large growth stocks that outperformed for several years (and which we have mostly avoided); they have disappointed investors lately, and many seem to have seen their profits peak. If future profits disappoint, we think that will cause further downside pressure for overvalued stocks, with reasonably priced stocks limiting downside damage.

Also, possibly contributing to downside pressure are historical trading patterns; as you may recall, January 2018 was an excellent month in the stock market, but it gave way to a violently volatile February. Since a lot of stock trading is systematic and automated these days, the computers may incorporate this time of extreme volatility into their algorithmic trading and lighten up on stocks in February to avoid a

possible repeat. This could cause some serious (but probably short-lived) pressure on stock prices late this month or early in February.

However, and importantly, the newly dovishness of the Fed may offset these downward pressures, either wholly or in part. The Fed has proven to be the major engine of higher stock prices over the past several years, and the pivot toward dovishness has already helped markets recover strongly from the lows of late December. The signaling by Fed officials that they are stopping the gradual but steady (quarterly) rates hikes of the past couple of years is a big policy shift. The potential lightening or stopping of QT, as indicated by Fed Chairman Powell in January is a further, bigger signal of a change of policy to distinct dovishness. As stated earlier, this appears to be in response to flagging economic growth indicators, but, as we all know, a dovish Fed is bullish for financial markets, especially the US stock market.

European stock markets, despite fundamentals weaker than their American counterparts, have mirrored US stock market moves, although European stocks have performed more poorly, especially financial stocks. However, much as US stocks have rebounded strongly off their bottoms, European stocks, as represented by the Stoxx Europe 600 (largest stocks in Europe), have had a strong recovery so far in January. As presented previously, Euro-area fundamentals, led by Germany, have been weak and getting weaker, but rallying US markets and the ECB's continued dovishness have combined to give a boost to European stocks, pretty much across the board, including financials and areas of concern like Italian and Spanish stocks. Thus, we will continue to shy away from European exposure until economic fundamentals start to improve but will continue to own and possibly look at additional global-market companies that are domiciled in European countries (Royal Dutch Shell being one example) whose cost structure and worldwide exposure make them attractive.

As noted above, Chinese stocks have on balance fallen for most of 2018 as the economy was slowing. However, stimulus by both the Chinese government and their central bank have helped arrest the drop in equity markets, with stocks not dropping to new lows in late December (as happened in much of the rest of the world). Since then, prices have recovered to the highs of the fourth quarter, bucking the trend of the past few months. Although fundamentals don't seem to have changed much yet, the improving price action has us looking at Chinese (and thus pan-Asian) stocks for possible new investment, including Australia, Vietnam, etc.

Japanese stocks, which attracted us in years past due to the weakness of the yen and the support of the Bank of Japan, have underperformed the US and especially Chinese stocks in the fourth and early first quarters. The bounce for Japanese stocks off a -25% drop in 4Q has been anemic compared with other world markets, in addition to the yen being stronger, which hurts overseas investors. We anticipate steering clear of Japanese investments this year. Taiwan also looks unattractive, most probably because of China's saber-rattling about the possibility of invading the island in the future.

Emerging markets, and frontier markets, are starting to look more attractive. Most emerging markets, led by Brazil, have had a strong rebound from late 2018 bottoms, no doubt helped by the fading strength of the US dollar, making EM dollar-denominated bonds less of a financial burden. Brazil, with its newly installed rightist President Bolsonaro, is facing a renaissance of overhauled business regulations

and falling political and business corruption, boosting business confidence and restarting long-delayed projects. Frontier markets in Latin America and the Middle East seem to also be benefitting from the belief that a lower US dollar and stabilizing interest rates will be good for business in the future, as reflected by rising stock prices. We anticipate making some investments in interesting, under-valued companies or countries in this general sector.

Currencies

Our former bearishness on the yen and euro came from the dovishness of their central banks, reinforced by the comparative business conditions (and worsening growth) in these regions when compared to the US. In late 2018 and early 2019, as those currencies stopped dropping (and started showing some strength against the dollar), we profitably sold our long dollar/short yen and euro positions.

Now with the Fed potentially scaling back QT, and US interest rates looking like they are on hold (with financial futures markets indicating that the next move by the Fed might be **a reduction of interest rates)**, the market has now started to push down the US dollar more significantly. While we don't feel comfortable going long the yen or euro currently (due to the apparent continued weakening of their economies), we do hold investments that will benefit over time from a weaker US dollar (gold, oil and other commodity companies, most notably). We will continue to look for attractive investments that benefit from a lower US dollar, probably in emerging or frontier markets mentioned earlier.

Last quarter, we highlighted the vulnerability of the Canadian and Australian dollars due to their post-peak real estate markets that appear to be losing strength. The potential bottoming in China and at least some recovery of these "commodity currencies" give us some confidence into looking at companies in these countries, but not investing in their currencies directly.

Bonds

The mounting evidence for slowing US growth led long-term Treasury rates down below 2.60% for the 10-year in the first couple of days of 2019 as end-of-year capital requirements combined with December economic bearishness. After a bounceback in rates early in January, the signaled dovishness of the Fed has pushed 10-year Treasury rates back into the 2.60s. Despite heightened borrowing by the US Government and continued QT (at least for the time being), rates have moved down as more institutions bought longer-dated US Treasuries. We believe market participants are now pricing in continued weakness in the US economy, meaning the economy has not yet bottomed. We concur fundamentally, so we expect demand for bonds to continue as business conditions soften, with potential Fed easing action coming later in 2019 or early 2020 (as indicated by financial futures). Thus, we are bullish on Treasury bonds, up and down the interest rate curve.

Corporate bonds, which should get a tailwind from stronger Treasuries/lower yields, have more factors to influence them. The Fed's low interest rate program of the past ten years allowed a large number of corporate borrowers to either newly borrow or refinance prior borrowings at lower interest rates. Starting this year, many of those bonds are coming due, with interest rates higher and the US

Government (and currently the Fed) selling large amounts of bonds, creating competition for corporate bond offerings.

Investment grade bonds are facing the largest amount of refinancings in the next 3-4 years, although many junk bonds will also need to be refinanced in the next 2-5 years (many energy junk bonds were refinanced after the 2014-15 oil price collapse). With these dynamics in place, and the large amount of junk-rated bonds compared to investment grade and considering many of the investment grade bonds are only borderline investment grade at all (BBB ratings), we see ourselves steering away from corporates of all stripes, at least until we see the economy bottoming and credit rating agencies bringing their ratings more current.

Energy

We continue to be surprised by the vehemence of oil price bearishness that pushed down prices so abruptly during Q4 2018 and the continued bearishness in the face of what looks to be a more balanced supply/demand relationship. In our experience, supply concerns tend to be the fuel for longer-term gains in oil prices, while demand concerns tend to drop oil prices very quickly, as again happened in late 2018. While we are concerned about economic growth and the energy demand that accompanies it, we also think there are supply concerns, with excess production in the US Permian and in Alberta, Canada, both with almost no ability to get that oil in world circulation. Instead, excess is stored, leading to worse-looking storage statistics, but keeping a lid on supplies for daily use by the continually-industrializing world.

Continued supply drops and ongoing supply concerns in Venezuela, Mexico, Iran (sanctions starting to take its bite) and the North Sea seem to be helping support oil prices, albeit at only a $50+/bbl level, which is not a price that has shown to incentivize expanded drilling budgets in 2019 (so far, at least), despite rhetoric out of a number of companies that they can make money at sub-$50/bbl levels.

Thus, we are constructive but wary in our oil price forecast. We have also been conservative in our investments, keeping to super-majors that benefit from higher oil prices but also have large refining and chemical segments that benefit from lower crude input prices.

Natural gas prices again showed their volatility during the fourth quarter, spiking early when early cold combined with lack of stored gas available for pre-December/January usage. However, a relatively warm December restored supply/demand levels in storage, dropping prices from near $5/MMBtu for much of November back below $3/MMBtu at the Henry Hub currently. We continue to look for attractive investments in low-cost producers due to the continued increase in usage of natgas but are wary due to the seemingly unlimited deliverability of gas found in US shale regions.

Commodities/Precious Metals

Last quarter, we talked about the recovery of precious metals and mining company shares from lows seen during the summer. The fourth quarter proved that economic upset and political and economic uncertainty drives more investors to invest in gold and other precious metals and mining companies.

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Now, with the Fed moving to a more dovish stance, but economic conditions weakening throughout the world including the US, precious metals are gaining more traction in investor portfolios. Bottoming indicators like a retreat by the US dollar, mergers of mining companies to improve corporate profitability and efficiency and political/economic uncertainty have slowly buoyed gold and silver prices to the point where they are solidly above their 200-day moving averages, often used as an indicator of whether investments are in a bullish or bearish phase. With the late January Fed decision on taking QT off autopilot and suspending further rate hikes, gold has reacted sharply, breaking out to multi-month highs, as are a number of our mining stocks.

As we said last quarter, precious metals and mining shares are under-owned by the investment community after the 2015/2016 extreme lows and the mid-2018 bear market moves. Outperformance of mining stocks during a turbulent fourth quarter, now buoyed by a dovish Fed and more efficient companies, should continue during 2019. We continue to be bullish of this overweighted part of our portfolios, and we continue to try to upgrade our investments to take full advantage of attractive fundamentals. As an example, one of our favorite picks, Kirkland Lake Gold, has more than doubled (to new all-time highs) since its recent bottom in February 2018. Good managements and expanding production growth are being recognized by the market, a change for gold mining stocks.

Lastly, the gold complex has gotten some support from world central banks. Despite the Venezuelan central bank selling their large reserves of gold bullion for the past couple of years (no doubt on orders from the Chavez/Maduro governments, who used proceeds from gold sales to run the country as oil production fell relentlessly due to poor operating and lack of investment), other central banks have been buying gold in large quantities, in fact at the highest volume since 1967, according to a January report from the World Gold Council. The Russian Central Bank has been buying continually for years, but China's central bank reported buying gold for the first time since 2015 (while they sold US Treasuries). Turkey has been buying gold (and has been the big buyer from Venezuela) during 2018 as it tries to diversify away from US influence. Other purchasers in 2018 include Poland (largest gold purchase in 20 years), Kazakhstan, Egypt, Indonesia, the Kyrgyz Republic, Mongolia, the Philippines, Serbia, Surinam and Tajikistan. Central banks had been sellers of gold for much of the past twenty years, but an increasingly changing world political and economic situation has brought large buyers back to the market.

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Kanos Quarterly Commentary

Is It or Isn't It?

Everyone wants to know: is this a bear market and if so, is this "the big one"?

Last quarter, we reviewed a number of our investment themes to show their attractiveness, their technical setups and what was happening to the indices during October. Now, after having survived (and in many of our investments, prospered) during the market turbulence of late 2018, people want to know: is this a precursor to the big one?

Of course, there is no cut-and-dried answer because we often only know during or after these things happen. But we at Kanos have the job of constructing a portfolio for you that weighs the probabilities of various outcomes, including an extended 'down' phase in markets, and adapting investments to protect capital and as much as possible, while benefiting from changing stock market dynamics. Our protection of capital during December 2018, when most of our portfolios far outperformed the S&P 500 (and other market indices), is a good test of defensive capabilities. Now we need to further investigate the probabilities of an extended upside move in US and world markets and gauge its longevity and resiliency.

Below we have investigated market liquidity and structure factors, technical factors, market-based indicators and economic fundamentals to try to give probabilities of which direction the markets will take in 2019 and beyond.

Market Factors

Market liquidity and the structure of markets is less talked about in the popular financial press and television, although it does have distinct effects on markets and the technical state of markets and individual securities, in particular.

US stock markets have recently been judged to have 90% of daily trading done by algorithmic trading or passive strategies. While this number may or may not be accurate, it shows the large influence of trading that occurs in reaction to price movements, as opposed to corporate fundamentals or economic changes. While a number of algorithms are programmed to react to key words in economic statistics or corporate profit results, most systems are set up to follow chart patterns or price reactions and to take a preprogrammed position very quickly as a programmed scenario or risk threshold unfolds. On the other hand, passive strategies are many times just a supply/demand function, where investors send money into an index-following strategy, and that strategy buys that day, regardless of the fundamentals happening during market hours. In addition, with the old specialist system at US stock markets having fallen away, computerized market makers add liquidity at their own option, meaning they can (and have) withdrawn liquidity from the stock market when prices have gotten volatile, just when market players are looking for liquidity for efficient trade execution that doesn't move the market price when selling (or buying).

The reason we highlight these prevalent market players is their use of momentum or rules-based trades without regard for fundamentals or market positioning, which until recently were important variables for stock market participants. We have seen some serious market movements during 2018 that seem to have been exacerbated by these types of stock market players, leading to more volatile markets. For example, as we talked about in previous letters, February 2018 included a vicious correction after a powerful January rally; the correction was punctuated by a sudden rise in volatility that "blew up" some concentrated volatility products, which then sent large ripples into the rest of the market, culminating with a scary 1500-point daily range in the Dow Jones Industrial Average (DJIA) on February 9th. These moves were punctuated by computer-market makers leaving the market, making it less efficient and causing volatility to rise (tight bid-ask spreads in trading markets tend to dampen volatility). In addition, a couple of days during December 2018, a computer-sell program was sent to the market, and trend-following computer traders were triggered by the sell order to also sell as risk levels were tripped, resulting in days of 500+ point market losses in the DJIA, including a 650-point loss on Christmas Eve.

We believe this market structure is now set up for any large surprise to the market (a bellwether earnings miss, a political catastrophe, a natural disaster, etc.) that could trigger a lot of systematic selling which would cause increased volatility and a retreat of computerized market makers, resulting in a more brittle market; in the past, "flash crashes" in either individual equities or whole indices occurred in such an environment, which really hurt investor confidence. With rising debt levels for the economy and corporate balance sheets after years and years of cheap financing costs courtesy of the Fed, coupled with still-high valuations and a weakening economy, the setup for big market down-days is at its worst in many, many years. We worry that the recent market correction has not done enough to lessen the threat of this type of market move, which would mark another bear market following the one we've just experienced.

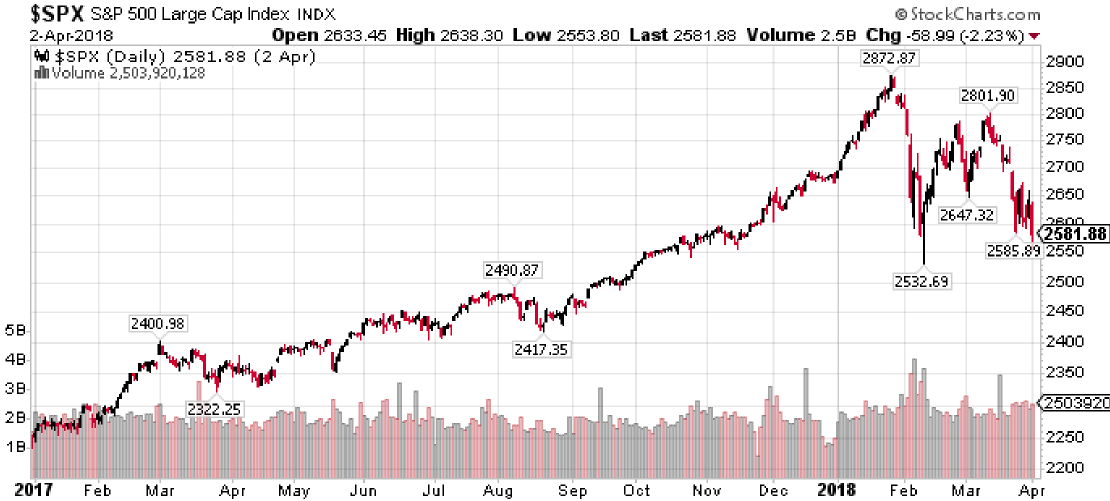
In summary, we are concerned that recent drops in various equities and market indices have changed the structural setup for many algorithmic traders, which, with some more weakness (such as another correction that takes us to a >20% fall from market highs), could trigger avalanche selling that feeds on itself. This is a concern because of the recent proliferation of computer-directed trading, although the threat has always been in the market; the difference this time is that computer trading can move very quickly and can control large pools of securities, larger in most cases than were concentrated in one "decision maker" in the past. On the flip side, of course, if the market recovers, these systems will contribute their monetary firepower and rapid decision-making on the upside, as we've seen at times in the past few years.

Technical Factors

Technically speaking, or looking at charts of the market to see if that can help give us a better idea of how stocks and indices have acted in the recent past as a possible precursor for how they will act in the future, the market is more vulnerable than it has been in the last three or more years.

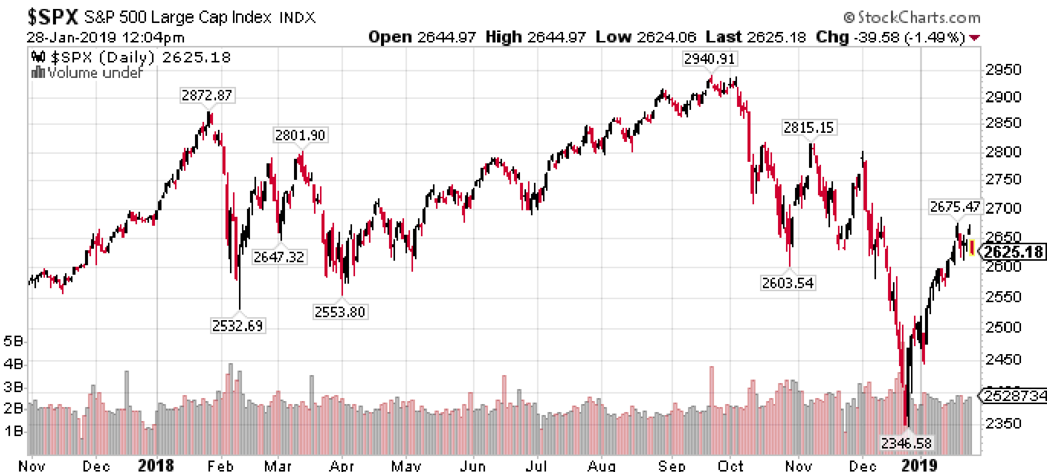
Here is an illustration. The following chart is how the S&P 500 looked during its long advance during 2017 and during the February-March 2018 correction. The market had set a new high in January 2018

at 2872, fallen to 2532, corrected back up around 2800, re-tested the low but found enough support to only get down to 2585, and then was ready to continue the advance:



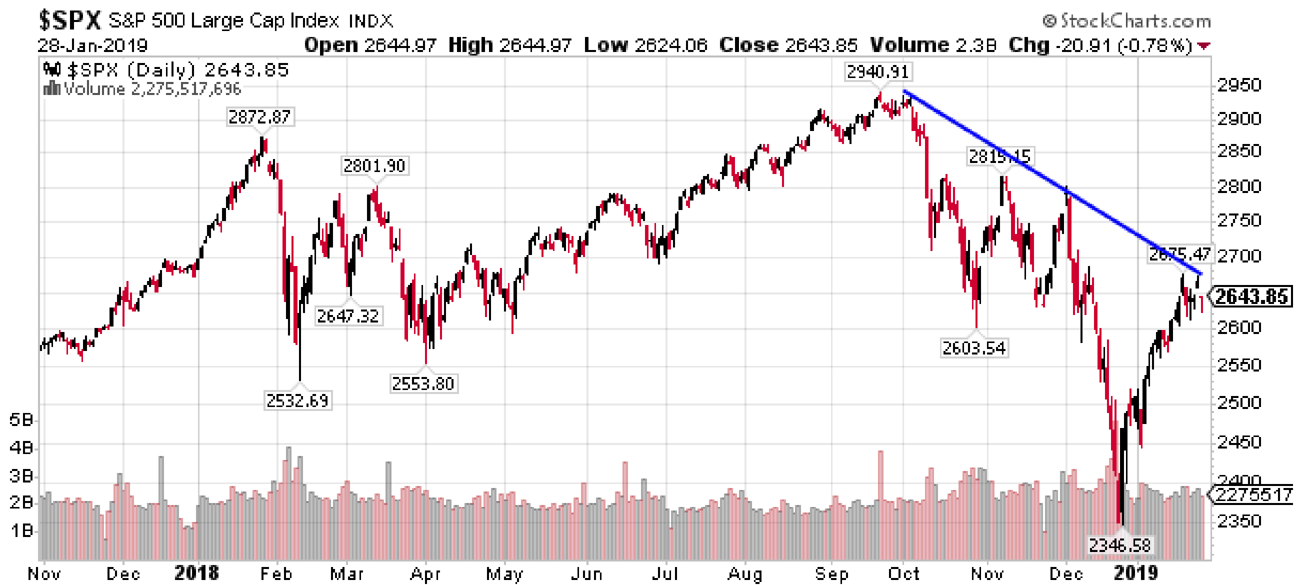
This was a scary but ultimately "healthy" correction that convinced buyers to come back into the market, culminating in a higher high in September.

The current setup is more tenuous for several reasons. Referring to the chart below of the S&P 500 from late 2017 through most of January 2019, it shows the correction described above, which resulted in a new bull phase after the late March low (which was higher than the February interim low, a bullish factor). From April through September, the S&P 500 rode new optimism, the Trump tax cut and high US corporate earnings to a new high. Starting in October, the market turned down; from its high of 2940, the market fell for most of October, with one "up phase" mid-month. November provided some strength, but the market tried twice to get through the 2800-2815 area, which it could not manage. This interim market strength gave way to weakness, and the market plunged during December, falling below all the previous support levels in February and March to a new low on Christmas Eve. The market has recovered strongly off of this new low; however, the advance has only made it about halfway back to the 2940 September high before finding some resistance during late January.



Visually, one can see in the chart above that the latest correction looks a lot uglier than the "classic" correction of early 2018. The recovery off the low, while strong and having risen a long way, looks to have lost steam at a lower level. This indicates less market strength than in the past, indicating a weaker condition for the market and a more tenuous setup for further gains.

Taking another technical look at the S&P, we can draw a trendline that connects recent highs to see if the downward trend has been broken by the recent "up" move. As can be seen in the chart below, with a blue trendline overlaid on the same chart, and connecting the early October high and the late November high, it appears that the latest recovery move has failed at exactly the point of maximum resistance to such an "up" move. This does not guarantee that the market won't advance after all, but as market technicians have seen for decades, if the market cannot get through a natural resistance point, there is a good chance it fails and goes back to test the late December lows (just as the February 2018 low was retested in late March 2018). This chart study is not predictive for us yet; what it does say is that late January/early February 2019 movements could dictate if the market gets through resistance at these levels or heads back down, trying to find buyers to buy en masse.



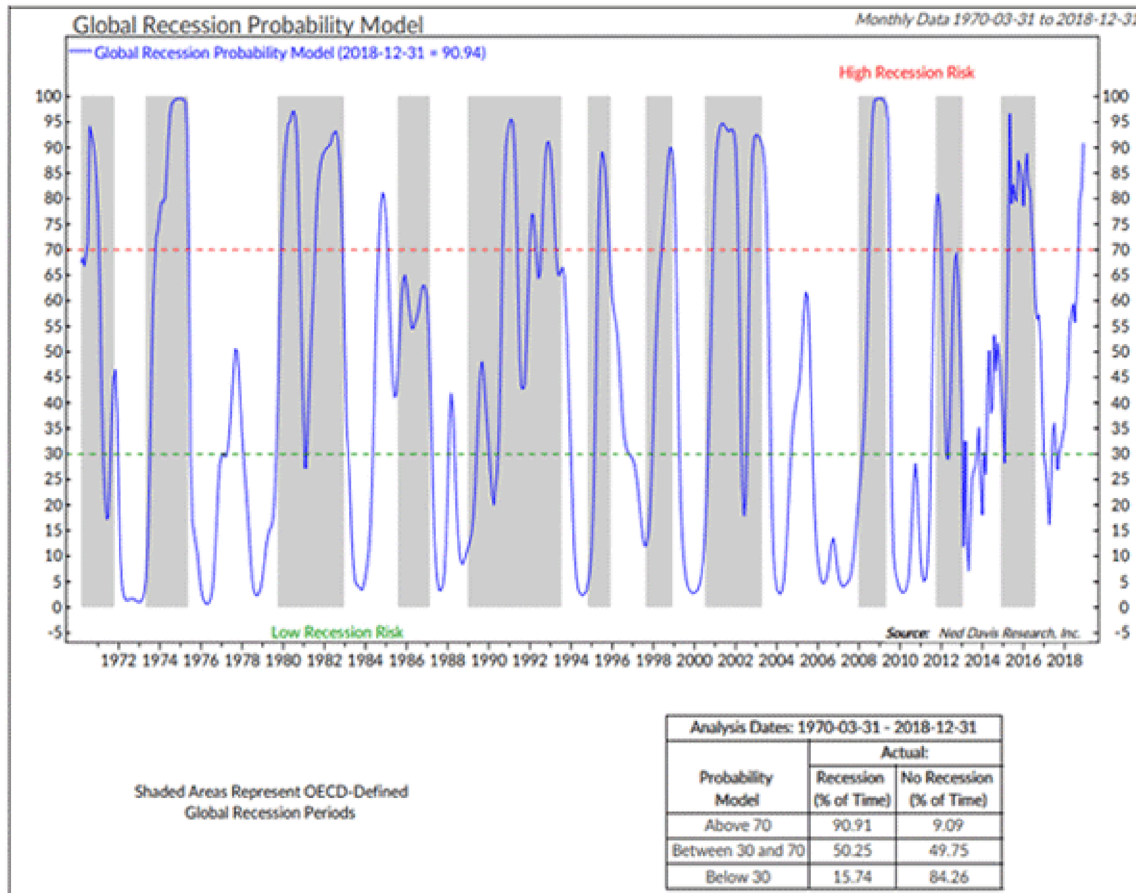
Market-Based Indicators

Recessions and bear markets often accompany one another. Bear markets happen more frequently than recessions, but the onset of a recession is a powerful force to weaken financial markets, so economic weakness on the way to a recession can often cause a bear market. Economic weakness in 2007, punctuated by housing weakness, had large negative effects on financial markets, helping cause the bear market that followed the October 2007 highs.

Several institutions and researchers have used past recessions to back test a number of indicators that rise during economic strength and fall during the onset of economic weakness to try to set up recession

prediction models. If the markets don't move to new highs (which would signal investors' belief that there is continued growth in world economies), and recession models indicate a higher probability of recession, then there is obviously a much higher probability of lower stock prices in the near future.

Ned Davis Research is a large US research firm that many investment firms worldwide rely on for its broad offering of research studies and historical perspective. We monitor some of their studies through the website of CMG Wealth Management, whose recent Trade Signals research piece titled Testing Overhead Resistance 1-23-2019 shows Ned Davis' Global Recession Probability Model (shown below). If a picture is worth a thousand words, this chart seems to indicate one thing: the world is in a global recession. This indicator has not risen above the 70 level since the 1960s without being in a recession or just before one hits (recessions are shaded in grey). With its current reading of 90, it seems like the world is in a recession or about to weaken further to officially be in a recession. <u>However, the good news is that the US economy has proven more resilient than the rest of the world in recent years and is not in recession currently</u>. Ned Davis' US market research studies show recession as not imminent. The "Economy Based on the Stock Market Indicator (High U.S. Recession Risk)," "Recession Probability Based on Employment Trends (Low U.S. Recession Risk)," "Credit Conditions – Recession Indicator (Low U.S. Recession Risk)" and "U.S. Economy vs. Yield Curve (Low U.S. Recession Risk)" [none shown] seem to indicate a lower probability of a US recession for 2019.



Analysis Dates: 1970-03-31 - 2018-12-31		
	Actual:	
Probability Model	Recession (% of Time)	No Recession (% of Time)
Above 70	90.91	9.09
Between 30 and 70	50.25	49.75
Below 30	15.74	84.26

Thus, many market-based indicators, captured well by Ned Davis Research's numerous studies, point to a more resilient US economy that does not look like it is heading into recession, lowering pressure on financial markets.

Economic Fundamentals Indicators

While economic indicators are not indicating a recession looming on the horizon domestically, indicators are showing growing economic risks. In a January 28, 2019 *Wall Street Journal* article entitled "Chances of Recession Are Rising," author Justin Lahart flags some other models with growing recession risks. He mentions "a study of economists polled by the *Wall Street Journal* indicate 25% give the US economy the chance of recession in the next 12 months, highest since 2011." More concerning, JPMorgan has a recession-forecasting model that puts a 43% probability of looming recession, while a New York Federal Reserve Bank model, based on Treasury yields, puts the probability at 22%, although Lahart notes that "the New York Fed's model reached 33% during 1998's financial turmoil ... and promptly retreated. The next year the economy boomed."

But other indicators are also starting to indicate levels which could lead to trouble: the US Treasury yield curve has inverted between the 1-year, 2-year and 5-year maturities, while the 2-year/10-year spread, a more classic measure of the yield curve, has fallen to 16 basis points, near the lows for the past several years. An inverted yield curve is a noted precursor to most recessions, although all inversions don't indicate looming recessions. The index of leading economic indicators (LEI) compiled by the Conference Board is also a classic indicator of approaching recession: when the leading indicators are negative for three months in a row, recession probabilities are high. The index printed negative for the first time since October 2017; if further weakness is indicated in the LEI over the next couple of months, the economy will probably be noticeably weakening.

Conclusion

The conclusion is, of course, that there is no conclusion yet. This is not "the big one" yet, as the market has acted "according to a familiar script" where weakness has been followed by a classic rebound. Although we haven't talked about fundamentals during this discussion, many in the financial markets attribute some or much of the weakness to the continued hawkishness of the Fed during the October-December period, hurting investor sentiment and causing market participants to downgrade their business activity and profit predictions. The Fed has walked back its rhetoric during January 2019, arresting some of the weakness in the market.

However, we have shown many studies point to a global recession and US weakening. So, although the Fed has started to talk about change, there has been no action to lower interest rates or loosen economic conditions their programs. Thus, until market indicators discussed above reverse track, we are prepared for, and continue to react to, weakening conditions with investments that can hold their value and pay dividends/interest, while finding companies and sectors that can grow despite an overall weak economy.

The Managers of Kanos Capital Management
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