KANOS
CAPITAL MANAGEMENT, LLC

Second Quarter 2019 Investor Letter

Portfolio Comments

Kanos portfolios performed well during the second quarter as we correctly anticipated the Fed's emphasis on easier monetary stance and the US economy's slower growth. Our portfolios generally outperformed, especially in June, as defensive positions held up and holdings that benefit from lower rates thrived. We tweaked portfolios but did not reposition accounts that were working as designed: we are still positioned with a "barbell" approach of stock market exposure, balancing stock market "beta" positions/easier money beneficiaries with fixed income and more defensive holdings.

Market Analysis - Looking Forward

Economy

We will cover many aspects of the US economy in our Kanos Commentary, "Markets and Economy are Diverging; When Will It Matter?" below, but we will give an overview in this section. The 1Q 2019 GDP ended up +3.1% and the 2Q 2019 GDP first estimate was just reported at +2.1%, so there is a slowdown in progress. Employment has held up, although at a slower rate than in the recent past. Business sentiment surveys/measures, the ISM and PMI reports, have shown decelerating activity, but they are not into contraction territory yet. However, the 3-month/10-year Treasury yield spread has been inverted for a month and a half, so this relatively reliable recession indicator is pointing to a more severe slowdown or possible recession 6-18 months out.

Bottom line: We remain optimistic the economy will continue to "muddle along," especially with the Fed now onboard, understanding worldwide weakness and growing domestic malaise. Anecdotally, it seems that large cities, especially those on both coasts, continue to prosper, and low (and expected lower) interest rates appear poised to continue to feed the amazing urban building boom which seems to be sustaining the US economy.

International economies, examined more in the Commentary at the end of this report, are struggling, with most developed countries on the edge of recessionary conditions and stimulating, both monetarily and increasingly fiscally, to try to stave off recession.

Emerging markets are in the same boat, mostly because of a slowing Chinese economy (which has been the primary consumer of raw materials that drive many of emerging market economies) and the strong US dollar (hurting the ability for countries to service their US dollar-denominated debt). However, a now-easier US Federal Reserve (Fed) is taking some of the edge off the strong dollar push with its signaling of lower US interest rates, and the strong possibility of some kind of trade deal between the US

and China (both need it at some point in the next few months to bolster their weakening economies/provide leaders with a political victory for their political bases) that might give a boost to Chinese demand and thus emerging economies.

Equities

Equity markets have obviously been strong in 2019 as they rebounded from a horrible 4Q 2019. The "Little Engine That Could" economy in the US continues to provide remarkably stable demand for products and services underpinning S&P 500 earnings. The continued evolution of the Fed's new easy money policy has driven the continuing rally, underpinned by an expected second half rebound in earnings, a change from the slight weakening we are seeing during the second quarter. The US market "wants" to continue to move higher, albeit at a more measured pace. Larry Fink, CEO of the world's largest asset manager Blackrock, predicted a "melt up" in equities earlier this year; we believe it is and will continue to be more of an "inch up," where indices and large cap S&P 500 stocks have measured gains and "two steps forward, one step back" advances throughout the summer. We do expect there will be a reckoning between the messages being sent by equities (continued expansion for next few months/years) and bonds (slowdown that the Fed better address immediately or risk bad financial outcomes) in August/September as companies see monthly results and give forward guidance either reiterating their current forecasts (bullish) or cutting their forecasts due to the absence of a meaningful fall-winter pickup (bearish or possibly extremely bearish).

Thus, we will continue to be almost fully invested, but with our successful barbell approach of large cap US stocks that we still consider will deliver growth in earnings at reasonable (relative) valuations, coupled with a large weighting of more defensive sector investments, such as utilities, REITs, mortgage REITs and precious metals stocks that will benefit from rallying bonds, a lower dollar and capital preservation needs. The strategy has been working since early summer and continues to bolster our portfolios presently. The evolution of the US economy and earnings preannouncements in August/September will help us determine whether to shade portfolios more offensively or defensively.

With those thoughts in mind, we are still shying away from both international developed and emerging market stocks because the US economy is still the demand driver for profit generation, and we are still wary of continued dollar strength. Why? While the Fed has embarked on an easing cycle through their communication channels, we are still unsure of the rapidity of easing, and if non-US economies start to deteriorate at an increasing pace, the ECB and other central banks may be forced to ease sooner and possibly faster than the Fed, causing other currencies to further depreciate against the dollar, causing relative US dollar strength, which would be bearish for international equities versus US equities (but still bullish for precious metals, in spite of relative strength of the US dollar).

Bonds

Bonds rallied for much of the quarter, driven by slowing economic growth around the world and, increasingly, in the US. The US 10-year Treasury yield actually rose during the first half of April as

anticipation of improving corporate results from the first quarter pushed rates up to 2.60%. However, falling governmental and Fed surveys and statistics weighed on Treasury yields. From the mid-April highs, rates dropped almost constantly, closing the quarter pretty much at the 2.00% level. Another notable feat was the 10-year/3-month Treasury yield curve trading for virtually the whole quarter (except a few days in mid-April) in an inverted-manner, showing a flight to safety in which investors eschew a time premium of the 10-year to keep an attractive yield for the perceived future drop of short-term rates.

Looking forward, the economic statistics have continued to deteriorate, meaning we believe we will see more of the same – falling rates that reflect softer business conditions. US surveys of business conditions mentioned above (the ISMs and PMIs) have shown weakness for the most part, with the Manufacturing segment approaching contraction and the Services segment reaching its lowest level since 2016 (the last non-recessionary slowdown). US rates also seem to be getting some downward pressure from European rates, which are falling on even worse economic conditions than in the US; to wit, the German 10-year Bund just traded to -0.40%, almost 250 basis points below its US 10-year Treasury counterpart, and at the same level as the ECB's overnight policy rate. This yield curve inversion for the German bond market is signaling a probable recession in the next year or so. We see bond rates falling around the rest of Europe also. We believe corporates will also participate in falling rates and rising prices, although we are cognizant of corporate distress and would keep any investment to investment grade. Junk bonds (supposedly "high-yield bonds") have been trading higher along with stocks, meaning they have lower yields; in fact, Bloomberg reported July 9 that there are fourteen junk bond issues denominated in euros trading at negative interest rates! Euro junk bonds are unattractive to us here because of their lack of covenant protection for lenders, the large number that are low-rated and the rating agencies' higher rankings versus fundamentals (in other words, ratings too high for corporate conditions), as well as the miniscule or negative yields.

We do see rates moving lower over time (although there could be some scary temporary reversals at times). We have looked in our portfolios to extend maturities, investing in highest yielding, safer Treasuries and investment grade corporates, and finding high-yielding CDs for maximum safety in some accounts.

Currencies

After falling for most of 2017 and bottoming in early 2018, the US dollar had been on a relatively straight line upward until June, when Fed signaling not only by Chairman Powell but by also by other high Fed decisionmakers pointed to lower rates. The markets have immediately pushed the dollar down from recent highs, reflecting the thinking that US interest rates have the most room to fall, which would make the US dollar increasingly less attractive over time. We see those forces continuing to push the dollar down over time, although it has not fallen since the Fed has not actually started to act. We also believe that financial upset, whether a stock market decline or financial failure, either internationally or even domestic, will lead to a rise in the US dollar, although not permanently. Al-in-all, we will be investing in things benefitting from a lower dollar, cognizant of sharp retrenchments at times.

Other countries, responding to slowing economic conditions, that have resorted to cutting interest rates have seen their currencies drop, most notably Australia and China. Countries that are seen as having more stable interest rate regimes (that is a relative term, obviously), which include Japan and Canada, have seen their currencies rise as investors look for stable/higher interest rates and a stable currency. Europe has actually seen both – slightly falling long-term rates but stable short-term rates, which have stabilized the euro somewhat. European economic activity is nearing recessionary levels, so we are still avoiding euro-centric investments while looking to find attractive multi-nationals with global sales and cheap European cost structures; these are hard to find due to slowing growth profiles.

Energy

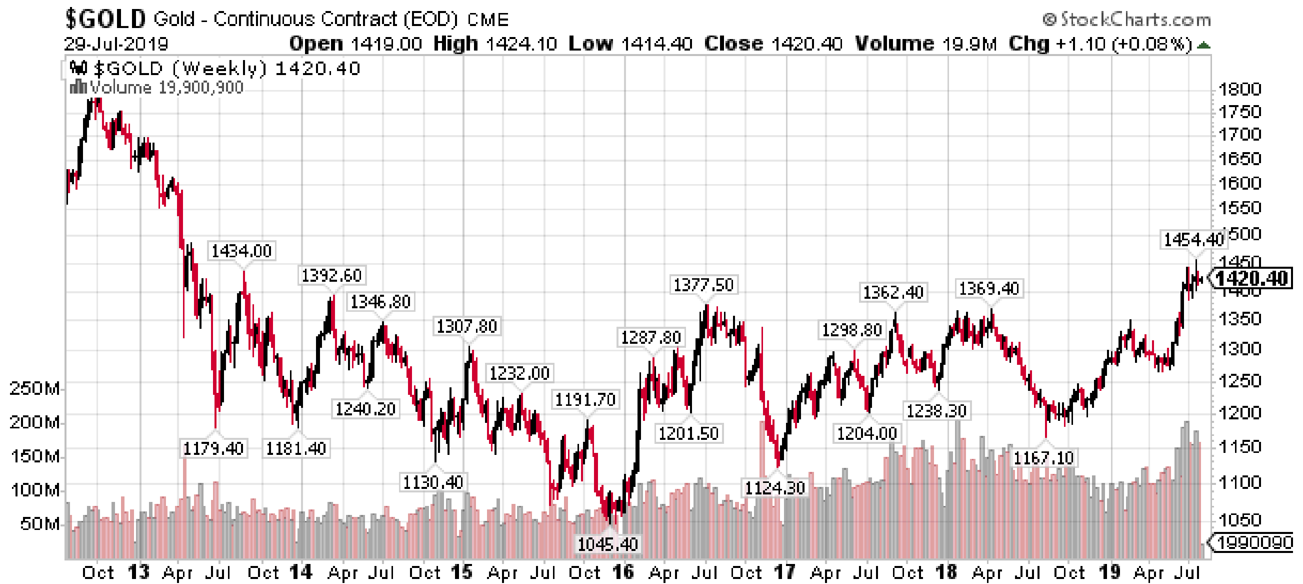
While energy has rebounded somewhat from its mid-2019 stall (WTI trading in the high-$50s/bbl and Brent crude in the low-$60s/bbl), the sector is still facing headwinds due to the perceived lack of incremental demand. Thus, most bullish points that have surfaced in the past couple of weeks (falling inventories, flat US production, serious fighting in Libya, low production levels from sanction-limited Iran, etc.) have shown pops in price that have been met with selling soon afterwards. It seems that the markets' perception of energy prices is still primarily demand-determined: slowing economic growth is most important. Supply concerns: adequacy of flowing supplies, storage levels (of crude and products) and supplies from troubled spots, carry less weight. Thus, we maintain our limited exposure to energy, holding supermajor investments that balance upstream production (benefits from higher prices) and downstream marketing of gasoline, diesel and petrochemicals (benefit from lower input prices). Stock prices of the supermajors have fluctuated but not fallen as much as pure production companies, meaning we have seen outperformance while staying in more conservative investments. Service company stock prices have vastly underperformed, signaling that investors don't see any relief for production companies in the near future; we continue to avoid investments in these companies. We do continue to maintain investments in pipeline companies, as the amount of continuing consumption is high, earning relatively constant throughput fees which maintains payouts to investors.

Commodities/Precious Metals

Commodities, and precious metals specifically, are usual beneficiaries of a lower dollar. While a lower dollar provides a certain tailwind for these investments, many are economically sensitive, so we have been and will continue to invest judiciously in sectors. With the dollar not having dropped and economies around the world showing growing weakness, we have and will continue to invest in commodity investments that aren't completely tied to economic "up" cycles.

Gold broke out in mid-June (after the Fed's latest meeting), above the $1,365/oz price ceiling it had not breached since mid-2013, as the Fed signaled easier monetary policies that markets see as leading to lower interest rates as soon as July. Easier monetary conditions internationally, combined with both increased geopolitical and trade tensions, had led to gold reaching multi-year highs in other currencies (most notably the Australian dollar and euro) earlier in 2019, so when the Fed signaled its intention to lower rates this summer, gold in US dollar terms also broke out (see chart below).

The gold chart below shows the gold price having broken out of a long curving base, breaking above and maintaining price levels above the peaks of the past six years. These interim highs, which served as resistance before, are now expected to serve as support for prices going forward.



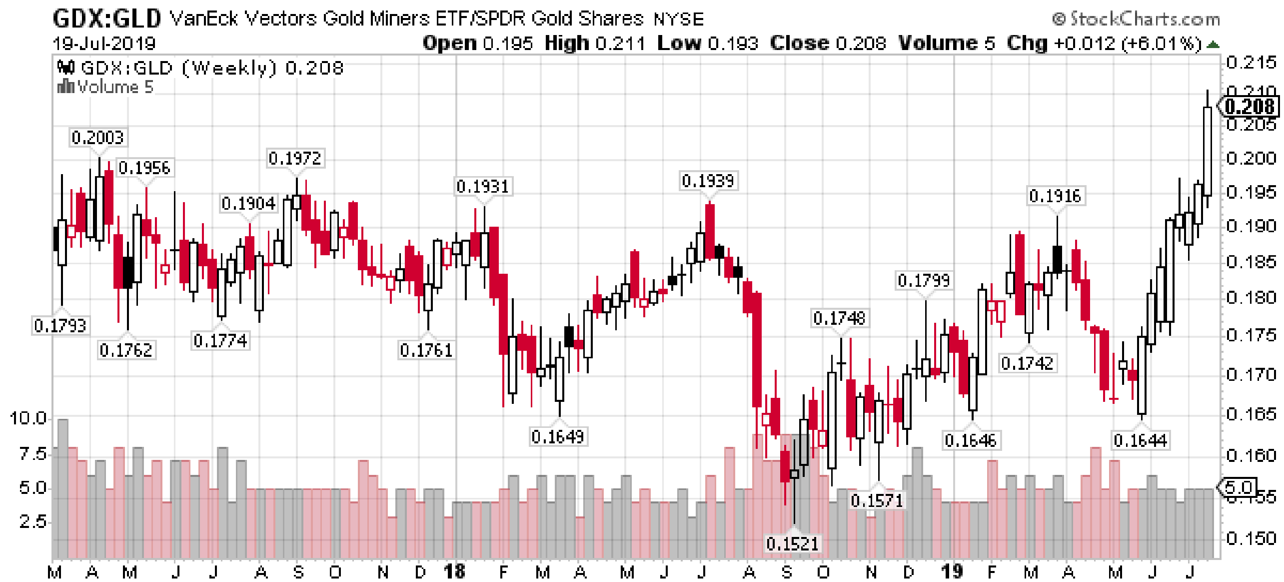
We believe this advance, which has happened at a time when the US dollar has not shown any sustained weakness, appears to have shifted gold's positioning from an inflation hedge and safe haven during disasters to a more bedrock investment for central banks and overseas portfolios as economic and governmental situations deteriorate. In addition, negative interest rates for governmental bonds and highly rated corporate bonds have led to investors moving to non-yielding gold and silver as better investments than guaranteed losses on negatively yielding bonds held to maturity.

Bull markets in precious metals are almost always led by mining shares and silver, and this market is "following the script" as this bull market breaks out to new highs.

The first chart is Gold mining stocks versus gold, as represented by the Van Eck Vectors Gold Miners ETF (GDX) versus SPDR Gold Trust (GLD); since gold miners have a lot of relatively fixed costs (land acquisition, plant and equipment at mine locations, salaries and wages, etc.), price rises for precious metals tend to fall to the bottom line of gold mining stocks as prices rise. Thus, since we believe prices of the precious metals will continue to rise due to our projections of falling interest rates, a lower dollar (eventually) and, consequently, more negatively yielding bonds around the world, we believe investments in mining companies will outperform the metals, and we favor a healthy tranche of our precious metals investments should be in miners.

If our projections are accurate, the market should start to buy miners at prices that reflect higher valuations as earnings and cash flow projections for miners rise due to higher precious metals prices. The miner/price of gold graph below shows that the market is supporting our position for higher metals

prices and gold miners' effectiveness at converting ore at current and future prices into attractive cash flows.



Similar dynamics to miners/gold apply to silver/gold. As investors (and central banks, to a lesser extent) see gold prices rising, the attractiveness of silver tends to increase. Less silver is mined from primary silver mines (i.e. a lot of silver supplies are produced as byproducts of other mines including lead, zinc and copper mines) and lots of silver is consumed in industrial processes, so silver tends to be much more volatile, both up and down. Thus, looking below at Silver versus gold, as represented by the iShares Silver Trust (SLV) versus SPDR Gold Trust (GLD) in the graph below, silver has broken its long drop in price and is now increasing in price versus gold (see lower right corner):

Gold mining shares have participated, with higher-grade, better balance sheet companies outperforming currently as investors have embraced more conservative investments (physical metal ETFs, major miners and well-financed intermediate producers). More speculative investments, like junior miners, exploration-only companies and more economically sensitive silver and silver miners, have just started to outperform as the breakout is still a new phenomenon for many.

Continued buying by world central banks (interestingly now led by Chinese purchases, who purchased another 10 tons in June for its seventh month in a row of buying) have provided an increasingly larger and consistent buying force. The increase in negatively yielding bonds (Bloomberg reports there are $13+ trillion of bonds worldwide that are negative yielding) continue to drive investors into better yielding investments like gold and silver (yield of zero!).

We will maintain our more conservative gold and gold-mining investments, expanding only to well-financed, less speculative smaller companies in portfolios suited for these types of investments. As the advance progresses, we may expand our investments as conditions dictate, mostly in portfolios that are underinvested in precious metals positions.

Base metals investments, such as copper, iron ore, steel, etc. have fared worse than precious metals as investors fear falling demand from flagging economic activity worldwide will match or overcome more attractive fundamentals from a falling dollar and still-attractive supply fundamentals. Iron ore companies have outperformed lately as Vale, the big Brazilian iron ore producer, has cut back some production due to its large dam-break disaster months ago. Copper rallied early in the year but has given back almost most of its gains as demand concerns again trump attractive supply fundamentals. Steel stocks have been a disaster, as US tariffs have not done their job and all steel stocks have suffered, US steel stocks the most. Thus, we have and plan to avoid these segments until some kind of balance is reached between demand and supply expectations.

Interestingly, the huge storms and resultant flooding in the US Midwest has led to some developing situations in select agricultural commodities. Attractive fundamentals combined with some interesting technical price patterns in corn, soybeans, cotton and coffee are on our radar screen as possible investments. They all have ETFs in which to invest in stock markets if we determine that the opportunity looks very attractive.

Kanos Quarterly Commentary

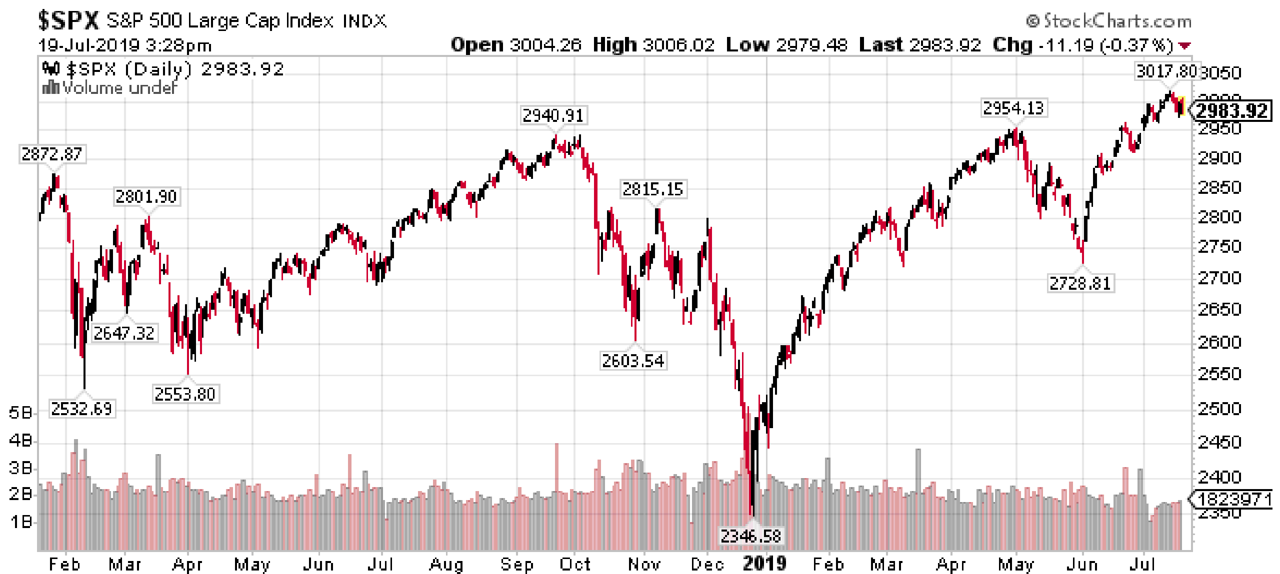
Markets and Economy are Diverging; When Will It Matter?

Throughout history, while many investment trends have had long lives, economic forces and market results eventually interact in classical textbook ways, i.e. strong economies spawned strong markets, although timing has never seemed to occur at regular predictable intervals. On the other hand, weak economies have led to weaker equity markets, but timing was definitely varied among episodes. We are now back at such a juncture, and we want to make sure we manage your portfolio to participate in

further upside while having enough defensive elements in the portfolio to preserve value when the inevitable market reset makes life in equities unpleasant for some period of time.

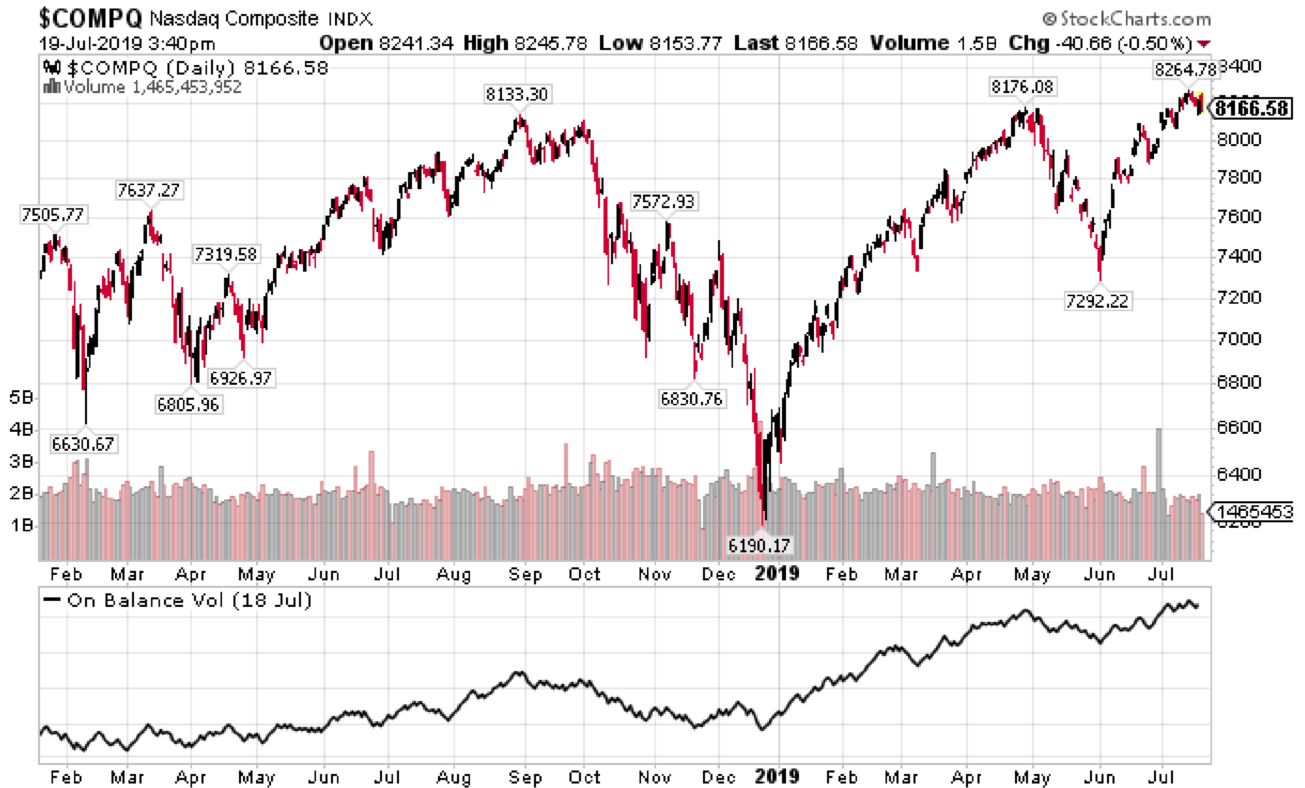
Let's start by further examining market action. In a nutshell, US equity markets continue to move to new highs (at least the large caps, but more on that later) and don't show many worrying signs of deterioration, after recovering from the large drop caused by the Fed's overtightening of monetary conditions last winter.

The following S&P 500 chart shows highs over the past 18 months, with some healthy (and one unhealthy) corrections. The big unhealthy correction was caused by the Fed over-tightening interest rates, which stock market participants judged to be detrimental to future earnings expectations, which caused mass selling of stocks (and drove the S&P down almost -14% during the fourth quarter). The Fed has since indicated it would be easing interest rate levels, and the market has recovered.



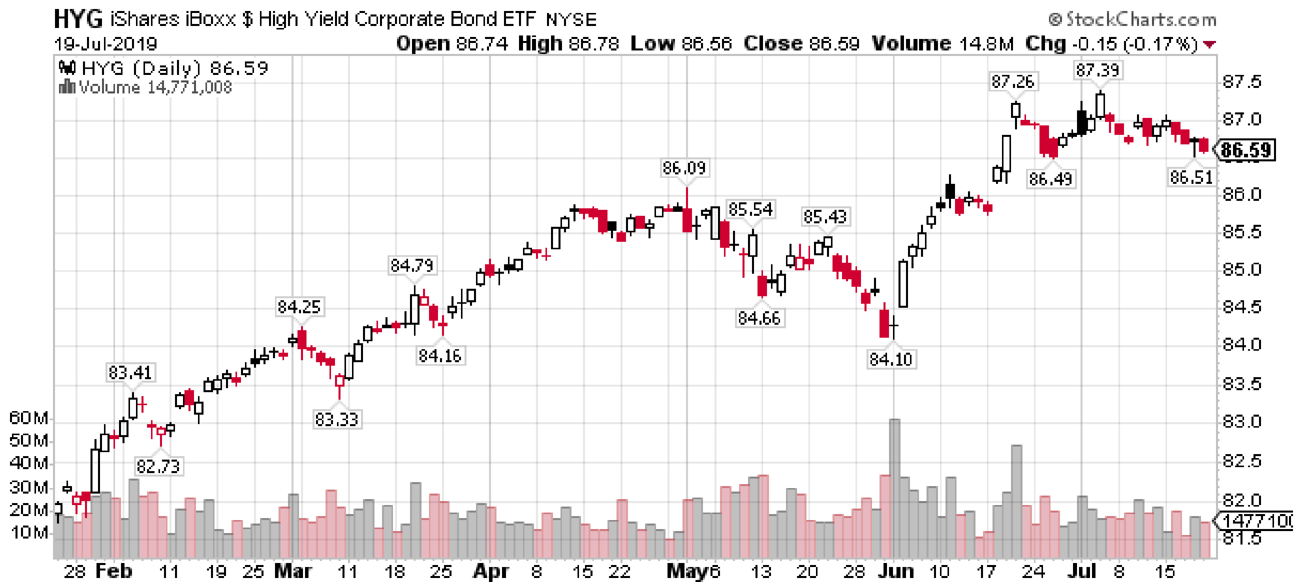
The technology-heavy Nasdaq has a virtually identical chart: three higher new highs in the past twelve months, with corrections in between. The Nasdaq has shown the most resilience over the years, and its largest member companies (the FANG stocks, Microsoft, semiconductor stocks, etc.) have grown so large that they also influence the S&P 500 strongly, hence the similarity in charts. The chart still points toward higher prices currently.

On the Nasdaq Composite chart on the next page, the attached indicator on the bottom, On Balance Volume (OBV), is a measure of accumulation, and it is a concerning element: its high reading shows us that Nasdaq stocks have been highly accumulated, or in other words, "everyone owns the market." This is concerning because the market needs more buying to continue upward and the OBV reading shows many investors are already fully invested. However, we don't see this as being a decisive factor due to the proliferation of systematic strategies that invest more mechanically and/or periodically over time, not taking into account technical factors or other elements mentioned later in our discussion.



Lower interest rates are sustaining the market. As seen in the 2-year Treasury note yield chart below, rates have moved to being much more supportive. On the left side of the chart, during most of 2018, rates rose as the Fed pushed up its Fed Funds rate. When market participants sensed the Fed had raised Fed Funds rates too high (November-December), the 2-year Treasury started moving down in yield, anticipating Fed easing. The Fed signaled its intention to ease in the future in late December and early January, which verified the move. This chart is illustrative because it shows how low interest rates have dropped, which are supportive of higher stock prices (at least in the short term, lower interest rates should lead to higher earnings and thus, higher stock prices).

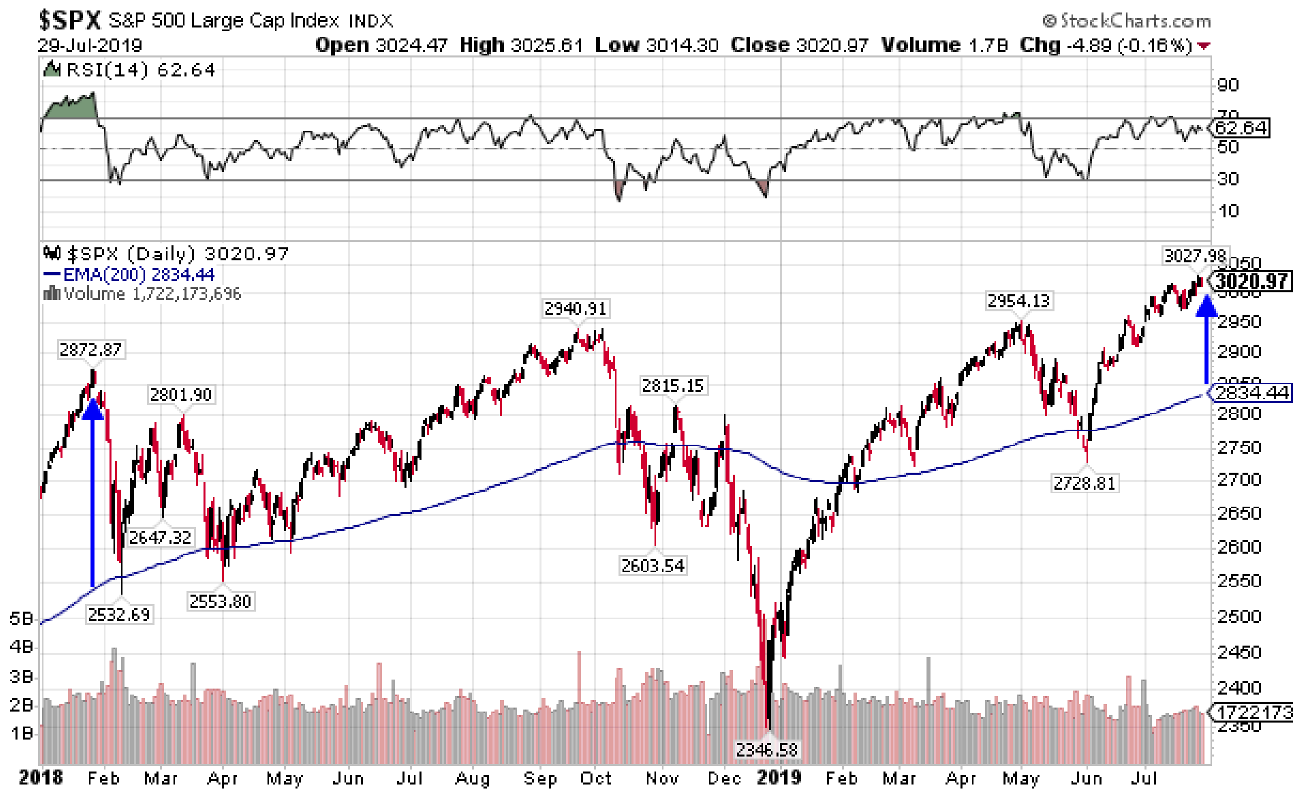
The strength in fixed income markets can also be seen in high-yield or junk bonds, which suffered during the fall-winter "swoon" but have benefitted since from supportive economic conditions. The following chart, showing the iShares High Yield ETF (HYG), shows little stress in junk bonds from economic conditions and a similar shaped chart as the S&P 500 without the magnitude of the drops on corrections.



Other technical indicators also show market health; again, looking at an S&P 500 chart (below), we have added a couple of technical features to help gauge where the market is currently positioned. The dark blue line through the middle of the chart is the 200-day exponential moving average (EMA) which illustrates the trend of the market over the last ten months; this line is a good gauge of whether the market is too far ahead (above the line) or oversold (below the line); in this case, the market has attracted buyers since it last corrected in May, rising above the 200-day EMA (see the blue arrow on the right side of the chart). While the market is slightly over bought, it is not extremely so, which the market was in January 2018 (blue arrow on the far left side of the chart) As you can see, this extreme led to a correction in February 2018 that pushed the market back down briefly below the 200-day EMA. Generally, advancing markets will spend more time above their rising EMAs and then correct periodically to "vent" the buildup in buying pressure. Currently, the market is on the higher side but not at any extreme.

Also in this S&P 500 chart below, there is an indicator on the top of the chart called the Relative Strength Indicator (RSI) that measures how recent moves in the price compare versus the recent past prices, with high RSI values occurring when prices rise quickly, and low RSIs occurring when prices drop precipitously. RSI values are most useful when they register at extremes, which are 30 on the lower side and 70 on the upper side. In the S&P chart, one can see that the chart showed oversold conditions in October and December 2018 (dark RSI chart patches when values are under 30) and a dark green spot when slightly overbought conditions occurred in late May (coinciding with the S&P 500 reaching 2954.13). Currently, the RSI is near 62, a slightly overbought condition but where the market

has spent a lot of time in the last few months, showing the market is not expected to make any big moves in the near future.



Thus, technical indicators and general movements in the US equity markets point toward a healthy advance (after the Fed changed its stance) that is in line with conditions over the past couple of years in which the market tended to move up along with economic expansion in the US economy.

Conversely, economic statistics are signaling the possibility of a very different future. A growing number of economic statistics show that the US economy is weakening, and seemingly not as strong as the stock market or as unemployment statistics seem to indicate.

First and foremost, interest rates have been falling in financial markets, far in advance of any interest rate decreases mandated by the Federal Reserve's Federal Open Market Committee. Lower rates in the market show that traders expect the Fed to lower rates which absent any market dislocations or economic upsets (neither of which seem to be occurring currently) mean that economic conditions are expected to deteriorate. In the chart on the next page, the 3-month Treasury Bill, the shortest traded Treasury instrument, is currently trading near 2.05%, almost 0.50% below the current effective Fed Fund rate of 2.45%. You can see when the Fed Funds rate was raised in mid-December 2018 to 2.45%, the 3-mo Treasury traded at that level for almost six months but has dropped recently.

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Many market participants would say that the 3-mo Treasury reflects anticipated FOMC policy and not economic conditions, so we will look at the 10-year Treasury to see what a longer-term perspective is showing to market participants. In past recessions, traders and money managers have bought longer-term bonds, especially Treasuries, because they are viewed to be a safe haven, with highly rated bonds like Treasuries ensuring a return of capital and a return on that capital, as traders locked in returns. Other investments like stocks usually lose more of their value in economic recessions as earnings and cash flow drop (or even disappear), leaving less (or no) return for stockholders because bondholders are first in line to be paid off.

The chart of the 10-year Treasury bond of the following page shows immediate and unrelenting drops in yields as bond traders saw the Fed's December Fed Funds rate increasingly as a policy mistake that would lead to economic weakness. The bond market, considered one of the "best" indicators because it is the largest and most liquid market, shows that economic weakness is not only expected, but traders seem to think it may be either longer than initially expected or a deeper contraction as rates have continued lower pretty consistently since December, staying near the psychologically important 2% level in spite of its recent correction.

Supposedly the best indicator of impending recession is an “inverted yield curve,” which is when the longer-term bond yields drop below shorter-term yields. The 3mo-10yr spread is generally considered the most accurate forecaster, and the longer it persists, the bigger the chance of a recession occurring. The following chart shows that this yield spread has been inverted for two months, which in the past has been a long enough period to accurately forecast a recession.

Additionally, a number of entities conduct surveys and have composed indicators that have worked in the past about indicating economic strength and weakness, both governmental and private organizations. There are a number of these indicators that have started to indicate worsening economic conditions.

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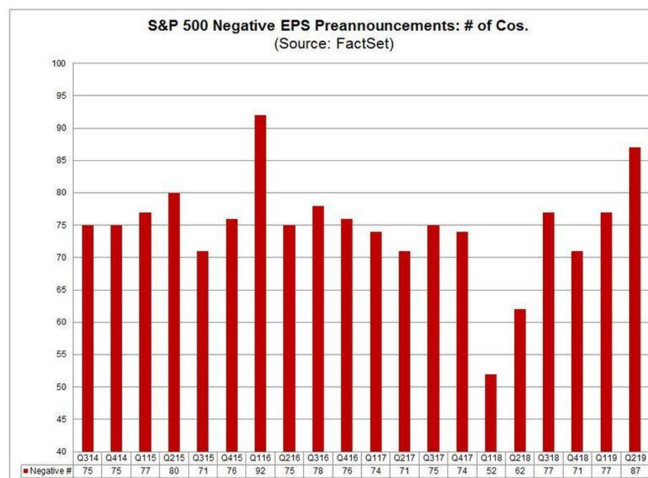
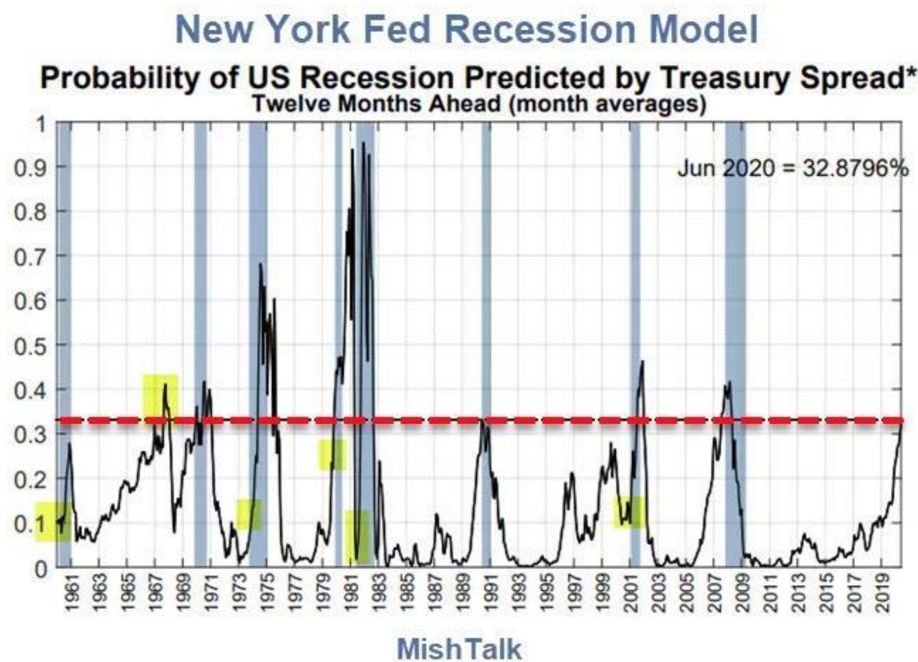
One indicator is Bloomberg's Macro Surprise Index, which measures the number of positive versus negative surprises in the US economy. These are not just indicators, but they are surprises, which mean that they are results that exceed (positive) or fall short (negative) of expectations. The chart shows that after reaching a post-Financial Crisis high in 2017, surprises have been trending downward since 2018, falling to net negatives in early 2019 and all the way to multi-year lows.

Another indicator is the number of earnings preannouncements by companies as gathered by the company FactSet. Companies are loathe to report bad news but are required by the SEC to preannounce earnings if they differ materially from company forecasts or widespread expectations. The chart below shows that 2018-2019 preannouncements have been increasing at a rapid rate and are at the second highest level since the Financial Crisis. This indicator shows that company results are deteriorating to the point that they are having to preannounce.

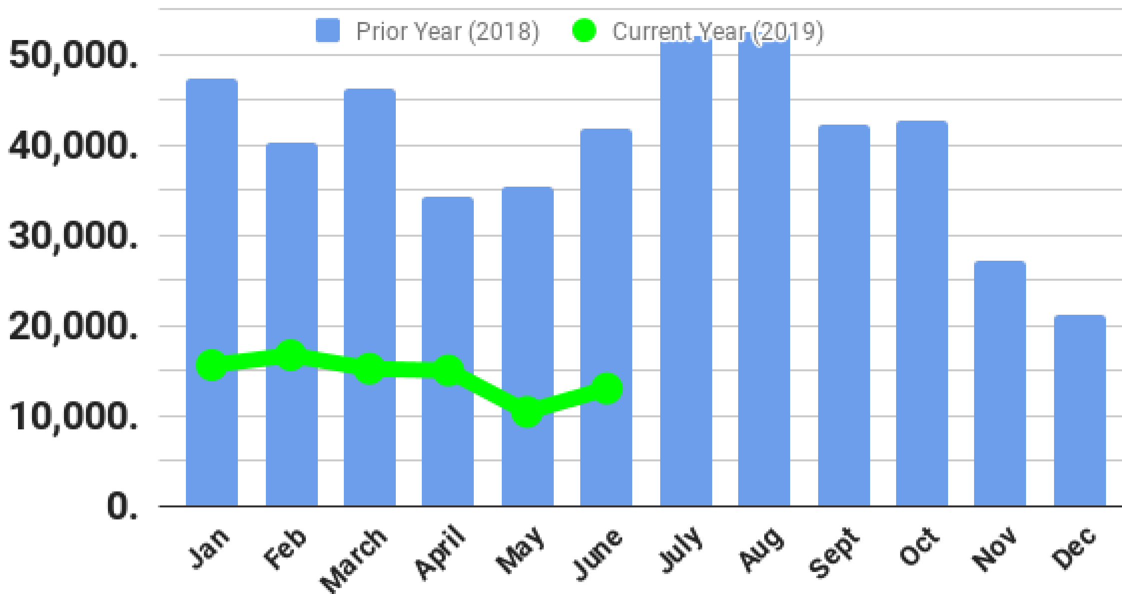


	Q314	Q414	Q115	Q215	Q315	Q415	Q116	Q216	Q316	Q416	Q117	Q217	Q317	Q417	Q118	Q218	Q318	Q418	Q119	Q219
Negative #	75	75	77	80	71	76	92	75	78	76	74	71	75	74	52	62	77	71	77	87

Another indicator is produced by the New York Federal Reserve Bank, and it is a Recession Model that predicts the likelihood of a recession. Below is a graph of the model going back to 1961 as produced by Mike Shedlock on his Mish Talk website. The model uses the Treasury Spread (the difference in Treasury bond yields in different maturities), and once it reaches approximately 0.3 ratio (indicated by the red dotted line), a recession has always followed as indicated by the blue vertical areas indicating recessions in 1970, 1974, 1980, 1982, 1990,2001 and 2008; the only exception to the indicator was in 1967. Now in 2019, the Treasury spreads (essentially that longer term bonds trade at lower yields than short-term bills) has driven this indicator to a reading of 0.329. This seems like a pretty compelling indicator, related as it is to the inverted yield curve discussed above.



On a more microeconomic basis, there are other indicators showing worrisome slowdown conditions. Manufactured products, both domestically and internationally sourced, generally reach stores using trucking. Lately, the US trucking industry has shown recent and dramatic weakness. Besides some very poor earnings surprises from US trucking companies and the sudden bankruptcy of LME Transportation, orders for new trucks have fallen off the proverbial cliff. The chart below, according to FTR data, shows Class 8 heavy duty truck orders, showing year-on-year drops of 71% in May and now 70% in June (blue bars are 2018 numbers and green line is 2019 orders).



This dramatic drop-off, coupled with trucking rates that have dropped as much as 40% year-over-year, are signaling a large drop in demand, in a sector that is essential to the supply chain for consumers, which constitute up to 70% of US GDP. This seems like a particularly worrisome data point for the US economy.

The abovementioned domestic US indicators, showing indicators close to the US economy are flashing serious warning signs, are probably what are worrying the Fed. However, economies are increasingly interconnected, at least since supply chains now regularly begin overseas in Asia, sometimes Europe and if not, in Latin America, especially Mexico. And money and monetary policy is generally fungible, meaning money created by the ECB in Europe can pretty easily be used to finance construction in Los Angeles or Ho Chi Minh City just as easily as in Paris. This means that growing weakness in demand can hurt the world economy in many different places, so we will look at some international indicators that show that slowdowns have already occurred in many places around the globe.

Obviously, China plays a huge part of world trade, as it now is the source point for a large number of unfinished and finished goods. In mid-July, China reported producer prices were unchanged year-over-year for June, the weakest since August 2016. "Producer goods (-0.3%) and Raw Materials (-2.1%) were the biggest deflationary drivers of PPI's weakness," according to the 7/9/2019 ZeroHedge article "China Producer Prices Signal Looming Deflation Threat," which also produced the graph below (PPI is the green line in the graph and CPI [consumer price index] is the red line). Accelerating disinflation/outright deflation in China, the manufacturer of the world's goods, shows the weakness afflicting the world's economies is bad and seems to be getting worse.

International weakness is occurring around the globe, and most worrisome, for us is Germany, the most efficient exporter to the world. According to Barron's 7/19/2019 article "Germany's Strong Stock Market Belies a Weakening Economy," German GDP is only expected to grow 0.5% this year, the slowest-growing economy in Europe. The PMI reports, which gauge private sector business sentiment, show weakness in Europe, especially the manufacturing PMI, shown in the graph below, which shows continued weakness and a divergence with the German stock market. Like the Chinese economy, the graph shows weakness not seen in more than three years.

A more market-oriented indicator showing investor concern over current and future economic conditions is what investors are willing to accept in yield from bonds. While there are guidelines that almost force some investors like pension funds and insurance companies to buy virtually all European bonds regardless of price (to match durations of cash flows with their liabilities to pensioners or life insurance policy holders), buying bonds at extreme low or negative yields seems like a non-starter. According to the 7/9/2019 Bloomberg article "Sub-Zero Yields Start Taking Hold in Europe's Junk-Bond Market," there are 14 corporate junk bond issues trading at negative yields, including bonds of Nokia Corp., two units of Altice (a European cable TV company) and a European subsidiary of Becton Dickinson. In fact, 27% of all of Europe's investment grade bonds are trading at negative yields, which includes corporates and sovereigns.

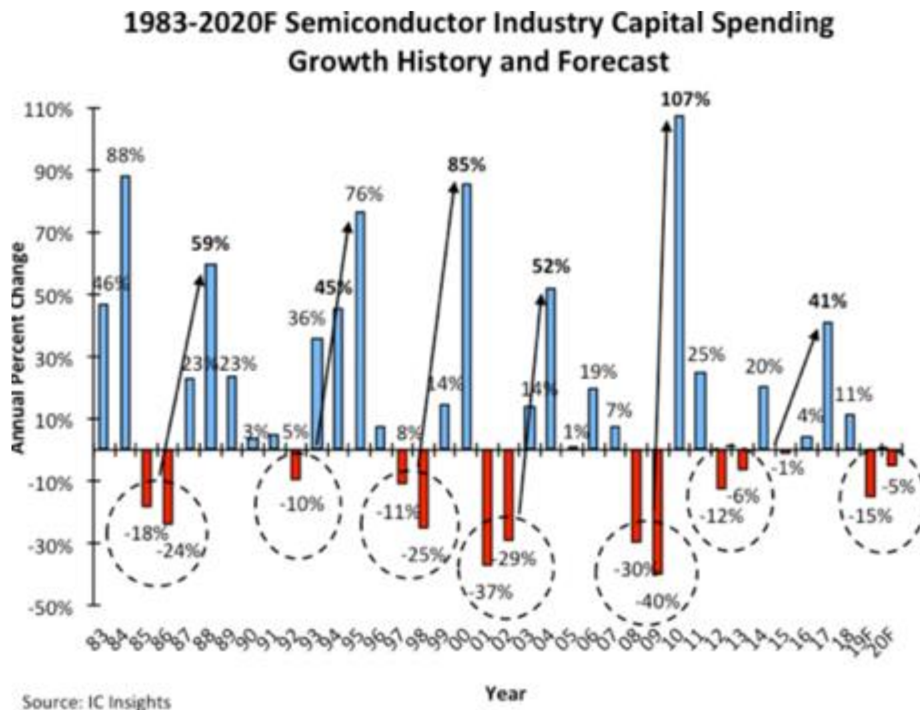
In addition, Bloomberg also reported that same day that Italian 50-year bonds were 6x oversubscribed with a yield of just 2.9%. Italy, which is currently in a fiscal fight with the European Union to try to further stimulate its economy and is desperate to cause more inflation (as is the ECB), is attracting investors at nearly a full 1% lower than Italian 5-year sovereign bonds traded for in mid-2018! Attraction to these bonds shows that investors anticipate further weakness and are willing to lock in these low rates, thinking lower rates will occur in the near future.

While it is not a large economy on its own, Singapore is one of Asia's largest trading hubs and has gained scores of companies moving from Hong Kong as Beijing tries to press its control of the former British colony. Singapore's growing importance makes it a good indicator for world trade and economic wellness. Well, the world is getting sicker, because Singapore announced a surprise drop in GDP last week for 2Q 2019, -3.4% compared to a +3.8% GDP reading in 1Q 2019 and expectations for 2Q 2019 of +0.5%. Results were ugly across the board, with manufacturing contracting at a -6% annual rate, construction declining 7.6% annualized and services shrinking -1.5% annualized. The same day, China announced that June monthly economic results showed a -1.3% decline in exports y-o-y, while imports dropped -7.3% y-o-y! While one month of data doesn't necessarily indicate a trend, China is an export economy, so even a month this low shows at least a temporary collapse. These are trade war "casualties" but show growing weakness throughout Asia.

One more obscure but potentially explanatory data point: while China's 2Q GDP was reported at a 6.2% annual rate (slowest since GDP was started to be measured in 1992), retail sales and industrial production surprised to the upside with a 9.8% y-o-y increase, confounding analysts and providing fodder for the corner of Western analysts who believe China makes up their economic statistics. Providing ammunition for this view was the subdata point of furniture sales in China, which showed a y-o-y decline of -14% from June 2018, as pointed out by Commodore Research, continuing a trend of eighteen straight months of declining furniture sales. Commodore added the following comments: "we continue to believe that there is a good chance that the ongoing plummet in furniture sales in China is pointing to much greater weakness existing in the Chinese housing market than is generally being recognized." Hmmmm, the plot thickens.

Finally, SEMI trade group, which includes more than 2,000 semiconductor companies around the world, published a report in mid-July warning that spending on new semiconductor fabrication equipment would be worse than previously thought, projecting a larger-than-before forecast of -18%

drop in semiconductor industry capital spending, down from their previous -8% forecast. IC Insights produced a great graph (show below) which shows the cyclicality of semiconductor capital spending indicating that this slowdown is the worst since the 2008-2009 downturn. These forecasts also bring into question the market's expectation for a second half resurgence in economic activity which underpins many valuations in the stock market for tech stocks, especially semiconductor stocks.



The differences highlighted above in market and economic statistics leads to the major question facing stock and bond markets since the end of the May 2019 correction in US stock markets: which is the correct predictor, stock or bond markets? Referring to the chart below from ZeroHedge's 7/14/2019 article, "For Markets, It's Back To The Most Important Question of 2019," bonds and stocks continue to diverge on what the future will bring, economic boom or weakness. Usually, 10-year yields drop when economic fortunes are judged to worsen over time, as investors lock in the surety of bond yields and the relative safety of holding bonds. When economies are expected to prosper, stock prices rise as investors are willing to buy into improving prospects and selling bonds due to diminished need for safety and certainty of return.

The stock market is projecting future prosperity while bond markets show growing concern of an approaching recession. Which is right? There is no answer yet. In the past, bond analysts and bond investors have usually better predicted future economic prospects due to the larger consequences in world bond markets and the idiosyncratic way bonds move due to "bond math." We believe we should see which side is right during the third quarter as second quarter results are announced and better visibility for the rest of 2019 surfaces during September and October.

While we think that valuation has mattered the least in our careers right now as far as determining short-term moves in the market (due mainly to passive and systematic allocation of capital to stock markets, which don't use valuation criteria to determine investment timing and could be as much as 80% of overall investment flows at any given time during the month), we think valuations eventually will matter, especially as quarterly earning results are reported and new data helps analysts judge how earnings changes could shift companies' perceptions in markets. With that in mind, Bank of America periodically marks a number of valuation metrics against the current level of the S&P 500, and the mid-July valuation metrics puts this market at a very high level, valuation-wise. As seen in the table below, 17 of the 20 metrics are considered overvalued, with Warren Buffett's favorite indicator, the S&P 500 market cap compared to the US GDP indicating 92% overvaluation!

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Table 1: S&P 500 Valuations -- borders denote metrics trading above their historical average (as of 6/30/19)

Metric	Current	Average	Avg. ex. Tech Bubble	Min	Max	% Above (below) avg	Z-Score	History
Trailing PE	18.1	16.2	15.5	6.7	30.5	11%	0.4	1960-present
Trailing GAAP PE	21.3	19.2	18.4	6.7	122.4	11%	0.2	1960-present
Forward Consensus PE	16.7	15.3	14.4	9.8	25.1	9%	0.4	1986-present
Trailing Normalized PE	21.2	19.1	17.7	9.2	33.9	11%	0.5	9/1987-present
Median Forward P/E	16.9	15.1	14.9	10.0	20.5	11%	0.8	1986-present
Shiller PE	29.7	17.0	16.3	4.8	44.2	75%	1.9	1881-present
P/BV	3.43	2.51	2.31	0.98	5.34	37%	1.0	1978-present
EV/EBITDA	12.3	10.1	9.7	6.0	15.0	22%	1.0	1986-present
Trailing PEG	1.24	1.44	1.42	0.93	2.21	-14%	-0.9	1986-present
Forward PEG	1.15	1.22	1.20	0.82	1.67	-6%	-0.4	1986-present
P/OCF	13.8	10.7	9.9	5.4	19.0	29%	1.0	1986-present
P/FCF	23.6	28.0	24.8	12.9	65.7	-16%	-0.4	1986-present
EV/Sales	2.54	1.87	1.78	0.86	2.91	36%	1.3	1986-present
ERP (Market-Based)	745	480	496	136	880	55%*	1.4	11/1980-present
Normalized ERP	412	307	350	-91	965	34%*	0.5	1987-present
S&P 500 Div. Yld. vs. 10yr Tsy. Yld.	0.89	0.63	0.63	0.17	2.30	42%*	0.7	1953-present
S&P 500 in WTI terms	53.8	24.2	21.6	2.7	109.0	122%	1.8	1960-present
S&P 500 in Gold terms	2.09	1.60	1.36	0.17	5.48	30%	0.4	1968-present
S&P 500 vs. R2000 Fwd. P/E	1.04	1.00	0.94	0.72	1.71	4%	0.2	1986-present
S&P 500 Market Cap/GDP	1.16	0.60	0.57	0.22	1.27	92%	2.0	1964-present

*Above average implied equities are attractive relative to bonds. Note: Trailing P/E based on GAAP EPS from 1960-77, Operating EPS from 1978-87, Pro forma EPS 1988-now. Trailing GAAP P/E based on GAAP P/E for entire series. Market-based ERP based on DDM-implied S&P 500 return less AAA corp bond yield. Normalized ERP based on normalized EPS yield less normalized real risk-free rate.

What the preceding few paragraphs have shown is that many world economies are slowing down appreciably, and the US economy is showing signs of also doing so. However, we saw the same thing in 2015-16 and that ended up being a growth scare. Governmental/central bank authorities actively moved to help support economic activity: Chinese rapprochement/currency deal (the "Shanghai Deal" where the US dollar was weakened by the G-20), increased worldwide monetary easing action by the ECB and Bank of China (and tightening pause in the case of the US, as Fed Chair Yellen had just started the tightening cycle) and the Asian fiscal stimulus allowed the world to avoid a prolonged slowdown then. Unfortunately, worldwide political cooperation is much more difficult currently, central banks are already easing, and fiscal stimulus is either being applied or is difficult politically – all different than in 2016.

Signs are pointing to this slowdown to being just as, if not more, serious than 2016, but worldwide stock markets, led by the US market, continue to inch ahead on a nearly daily basis, showing little worry that the slowdown will persist. In reality, most investors think further central bank easing will rescue world economies, but stock and bond markets are interpreting effectiveness very differently. Until some kind of resolution starts to show itself, we continue to want to participate in this bull market, albeit with a more restrained but still fully participating portfolio. Thanks again for your confidence and trust in your portfolio managers.

The Managers of Kanos Capital Management
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