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Second Quarter 2020 Investor Letter

Portfolio Comments

We are happy with the way our portfolios rose this quarter during the Covid-19 recovery phase, led by our precious metals positions and enhanced by technology and healthcare stocks. The almost unbelievable amount of stimulus applied both monetarily and fiscally has helped companies recover and provided "fuel to the fire" for stock market indices. Buying from underinvested large investors, both institutional and high net worth individuals/family offices, and opportunistic less-experienced investors has poured money into the stock market, attracted by stock prices lower than prior to the Covid crisis. This has led to almost all our positions rising from March low prices, although economic damage and looming economic risks have led to less recovery in our yield-producing positions. We kept on a hedge position due to very high valuations of stocks (that we have taken off early in the 3rd quarter) but otherwise feel that our positions, both defensive and aggressive, performed as planned and helped us stay in position for future rises and uncertainties.

Looking forward, our portfolios in the early third quarter have zoomed as gold hit all-time highs and miners moved to multi-year highs. Materials and utilities have also moved higher so far this quarter, helping Kanos portfolios, as have healthcare, technology and staples, in which we have smaller weightings. Our Treasury positions have held up well, despite heavy issuance to pay for the stimulus programs. We will go through the prospects for the sectors of the US markets in the Equity and Bond sections below.

Market Analysis - Looking Forward

While there are key themes we will talk about below that we think will power our portfolios upward, this is a very confusing time economically, politically and geopolitically. The rapid shocks of lockdowns stopped world economies in their tracks, and then differing amounts of stimulus and speeds of delivery have led to different levels of economic recovery around the world. We will examine what we think will happen in economies and markets, but the future is as murky as at any time in recent history.

Economy

The US economy suffered a nearly unprecedented slowdown with state-imposed lockdowns in most of the United States. The government and the Fed have reacted in a remarkable fashion, providing approximately $5 trillion of fiscal and monetary stimulus during the second quarter alone, which represents more than 20% of the US' annual gross domestic product. The stimuli are in response to an estimated -35% effect on second quarter business activity/GDP, a catastrophic crash. The true scope of these efforts can be seen by comparing this response to the entire program of unlimited quantitative

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easing ("QE3") that ran from 2012-2014: the Fed bought a total of $4.5 trillion during that time, and QE3 was widely credited with helping stimulate the economy out of its post-Great Financial Crisis ("GFC") malaise. Thus, the weakening economic conditions in late 2019-early 2020 were seriously impacted by the arrival of Covid-19 and the resultant lockdowns, requiring a previously unimaginable stimulus response by both the US Government and Fed. The issue now becomes how the economy will bounce back at the same time Covid-19 continues to affect many states. Most states re-opened their economies to a large extent during the second quarter, but the worsening of Covid-infections in most large US states has led to a pause or a slowdown in opening each state's businesses, with some states forced to reverse course. Thus, when looking through the lenses of business activity and employment, we are experiencing a "hiccup," which should show up in August releases of July economic conditions. This is important because it coincides with a number of announcements of company earnings which impact confidence, outlooks, business investment and most importantly, hiring.

The crosscurrents of supply, demand, confidence and economic reacceleration make the way forward a muddled picture. For the rest of 2020, the lingering of Covid-19 makes demand for discretionary purchases an issue, leading to supply gluts and discount sales needed to clear inventory and move arriving merchandise. This is happening as we speak, with huge discounts offered on apparel, sports equipment, etc. as retailers try to move their inventory and generate cash flow to pay their staff and fixed expenses. Other industries, like travel and entertainment, have had their activity curbed and have offered discounts to try to build back traffic. All of this has led to falling prices which, when combined with exceptionally low oil prices, has put a drastic disinflationary force into the economy. Meanwhile, sales of essentials and less discretionary items have been buoyed by lockdown unavailabilities, spot shortages and increased sales due to consumers stocking up, pushing up prices. Overall, the price of day-to-day living has gone up, sometimes significantly (one measure of prices of protein showed an 18% jump in 2020). In addition, the services side of the economy has become more expensive, as many servicers are plagued by lockdown interruptions (small business failures, worker Covid infections, etc.) that have caused less availability of services and higher prices, further hurting cost of living affordability. Surpluses of some things and shortages of others has led to deflationary and some inflationary forces in the economy, and the large amounts of stimulus provided by government have served to bolster consumers' purchasing power. The US populace is starting to get whiffs of inflation that the economy has not seen in many years.

In the longer run, demand uncertainties and the recent shock of lockdowns (accompanied by the potential for return of Covid-19 in another wave later in 2020 or in 2021) argues for US businesses acting conservatively in hiring and building inventory. This means continued slow GDP activity (slower recovery back toward early 2020 levels of activity) as businesses don't run near capacity in case of new 2020-2021 Covid shocks, while also continuing the possibility of shortages of goods and services, leading to price pressures and the possibility of increasing inflation.

In Europe, the European Central Bank ("ECB") has acted swiftly this spring, making money available to EU banks at even more negative interest rates, but the unwieldy European Union had not been able to get its 27 countries to agree on a fiscal stimulus package until just over a week ago. The EU agreed to a 750-billion-euro recovery plan, which had been in the works for weeks. This deal has allowed EU countries to start providing stimulus to their economies in the coming months as details are worked out,

since early Covid outbreaks in many countries, most seriously in Italy and Spain, impacted growth significantly. Interestingly, the lack of stimuli that has held back economic recovery has led to a higher euro, as other countries, most notably the US, have continued to flood their economies with monetary stimulus, making their currencies, including the US dollar, less appealing and driving them down against the euro. This strong euro has helped limit inflationary pressures and helped export receipts, despite lower demand from world economies. We don't think European economies will grow much after this blip up in activity due to already weakened economies; the reappearance of Covid in Italy, Spain and France; poor banking environment due to continued negative interest rates and the competing interests of the various European countries.

In Asia, economies have been in recovery for weeks after the initial wave of coronavirus hit China and surrounding countries. However, continuing Covid-related demand slowing from the rest of the world has held Asian economies to activity levels still far below early 2020 levels, especially with the low level of travel and entertainment activities allowed by governments. Now flareups in Covid cases in pockets around Asia have led to some renewed restrictions in some countries, further dampening economic activity.

China, while spouting statistics of renewed growth (albeit slower than pre-Covid), still shows signs of producing less growth than pre-Covid. Overall, Chinese economic statistics continue to be suspect, showing some growth in PMI surveys while showing almost no export growth and importing lower amounts than pre-Covid levels. Throw in that seasonal rains in industrial central China have been historically bad (threatening to rupture the Three Gorges dam, the largest hydroelectric dam in the world), and the thought of any robustness to the Chinese post-Covid rebound seems incredible to us. Their financial system has continued to see rescues by governmental entities, this time for failed insurance companies and non-bank financial companies, which means all is not well in the small company sector. We will continue to avoid anything but possible large company exposures, possibly only for trades and not long-term investments.

Other emerging markets stocks, while benefitting from the weaker US dollar, continue to make us nervous because of the impact of the Covid-induced worldwide recession and each country's seemingly continued fight against ongoing Covid infections, which lead to uncertainty and worse productivity. We currently are continuing to avoid industrial, service and consumer-oriented foreign stocks, taking our exposure through mining stocks.

Equities

The US equity market has again been led by the large technology growth stocks, which have pushed from a correction to "positive for the year" to new all-time highs as the tsunami of Fed liquidity combined with fiscal stimulus at investors' finger tips pushes stocks up in the fastest rally since the early 1930s (following the Crash of 1929). This liquidity continues to stream into the markets (albeit at a much-reduced pace), contravening economic statistics/results that still show the shock of demand destruction from this spring.

Helping the rally has been the re-emergence of the small retail investor, best characterized as a younger investor who has put his/her stimulus check into the millennially focused brokerage firm Robinhood. These smaller investors have bought into downtrodden, low-priced stocks en masse and proceeded to push up prices in several highly speculative issues. In the second quarter, Hertz, the bankrupt car rental company, was one big focus. Their activity continues in the third quarter, with Tesla being one of the big stocks "du jour" this time around. The activity is very reminiscent of small investors' behavior in the 1999-2000 time period when investors (big and small) embraced every new concept stock, hoping the newest "dot com" would become another Amazon. While the initial gush of liquidity caused momentum in a number of stocks post-crash during March and April (cruise ships/airlines), the reality of business prospects, solvency concerns and liquidity problems have "brought back to earth" a number of the "Robinhood favorites". We believe the majority of these small, inexperienced investors will overstay their welcome and end up with losses on these speculative positions. We have stayed away from stocks that could be "good trades" but have poor long-term prospects, wary of when large investors turn on them (Boeing being a good example).

The real question is this: how long does the market continue to rally if the economy is struggling to just get back to the economic activity levels of the past few years? The constant surge of passive investment money has now overcome both economic concerns and valuations to push large stocks, especially technology/communications/internet-oriented stocks to new highs, barely slowed by occasional pullbacks. Shorting has been largely unsuccessful due to Fed liquidity, passive flows and Robinhood speculators pushing large amounts of money into speculative trades, many with dubious or non-existent longer-term prospects (they typical targets of short sellers).

As in other times of high valuations, the longer-term prospects for growth stocks over the last few years is less favorable than before; however, their expected continued growth makes them attractive in a choppy economic environment, with Covid upsets lurking around the corner. It is impossible to know when there might be a break in the market; typically, market dynamics point to underperformance of equities in the September/October time frame, especially with the 2020 election bearing down on the market with no clear resolution as to which party will control the presidency or the US Senate. Thus, we see conditions in the market continuing through mid-summer but expect to see fireworks starting in mid- to late-August and into September. We like our mix of consistent but not fast growers in the pharmaceutical, defense, healthcare testing and technology sectors while trying to participate in a risk-limited way with the more highly valued technology stocks. We expect our highly successful precious metals equities will combine with these and more stable holdings (utilities and REITs) to weather the storms we expect during the second half of 2020.

Bonds

The fly in the ointment for recovery bulls has been the persistent bid for bonds, particularly long-term Treasury bonds. Ten-year Treasuries have varied between 0.63% and 0.75% throughout the post-Covid crisis (except for one spike in early June that took tens to 0.90% before yields fell back). Since mid-July, ten-year yields have moved down further, trading between 0.54% and 0.62%, apparently reflecting the re-emergence of Covid around the United States. This persistent bid, at a time when the Fed has actually been buying the least amount of Treasuries since the crash, shows investors' continued need for

yield (no matter how penurious) and safety (in spite of a recovering economy). In addition, the low (and recently falling) bond yields have tightened the spread with other sovereign bonds, leaving Treasuries less attractive to overseas investors and causing more weakness in the dollar. We continue to maintain our holdings in Treasuries for safety and a little yield, and we plan to do so unless we see further emergence of inflationary forces which drive Treasury yields above prior interim high yields.

Corporate bonds have benefitted from low Treasury yields with a continued bid from investors and consistent stimulus purchases from the Fed's surrogate, BlackRock, for the Fed's account. Investment grade bonds have rallied all through the spring and early summer, now providing little extra yield for the risk of lower credit ratings. High yield bonds have also rallied, but not as much as investment grade, with prices still down for the year on average. We own few, if any, corporate bonds and don't feel the small upgrade in yield is worth the extra risk, especially in high yields.

Municipal bonds continue to be more attractive than corporates, depending on their locations, ratings and insurance provisions. Non-taxable debt is getting more play as Biden becomes more credible as the possible President who has vowed to roll back the tax cuts enacted during the Trump presidency. Many municipalities have taken on increased costs, and thus more debt, in fighting Covid and loss of revenue from shutdowns of revenue sources (bars, restaurants, sporting events) makes them less certain for us going forward. Thus, we plan to maintain current muni positions but have not added to them as we try to understand which bonds may be attractive and which may be adversely affected by Covid.

International bond markets have only entered our radar screen as the US dollar has declined somewhat, but the threat of a dollar rebound, coupled with the shakiness of some countries' budgetary problems caused by economic slowdowns/fighting Covid, has held us back from seriously considering overseas bond investments. Finally, many European bonds are negatively yielding, making them non-starters as investments for value-conscious investors like Kanos.

Currencies

The US dollar, which had been strong during the Covid upset in March and April, has been hit by: 1) the continuing large amount of stimulus being applied by the US Government and Fed (more than other economies, causing concern worldwide about the amount of dollars being created), 2) the relative interest rates compared to Europe – US interest rates have been falling, while most European interest rates (with many being already negative) staying the same, making Europe more competitive and falling US rates less attractive, causing capital to move away from US markets and the dollar, and 3) the now uncertain political situation in the US with the 2020 elections up for grabs and political uncertainty at its highest in years, now accompanied by open rioting in the streets of many US cities, sights not seen in the US since at least the Rodney King riots of 1992. All these things have led to a now rapid devaluation of the dollar against most foreign currencies, most notably the euro. A weaker dollar has made assets, both domestic and international, go higher as foreign investors find assets cheaper. In addition, large amounts of international debt borrowed in dollars now can better afford to redeem in US dollars, lessening the stress of expensive US dollars during March (see the 10% spike of the US Dollar Index at the height of the crisis in the US Dollar Index chart below). Here is a chart showing the dollar's recent weakness:

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Obviously, other currencies have gained purchasing power as the dollar has weakened, although it also makes foreign exports more expensive for US consumers (still one of the stronger sources of demand for world economies). Export economies like China, Germany and many others will likely move to try to weaken their currencies to get more competitive prices and increase exports, but the latest move in the dollar will be hard to overcome.

We will look to continue to limit our international investments because we think foreign economies have become dependent on the US and being less competitive (due to higher prices) will hurt their competitiveness. We also think the recent continued weakness in the dollar will at least correct somewhat, to which international stock markets will react poorly.

Energy

Last quarter's disastrous drop in crude prices has ravaged the industry, leaving us to wait for the damage to pass through the players before we make any new commitments to energy investments. We still own the supermajors and some pipeline stocks in the US, all of which we consider less risky in a very risky sector. OPEC+ has shown production discipline by imposing some limits on the group's production levels and generally sticking to them. US shale producers have found it hard to compete in the low $40s/bbl. for WTI, and US production has been eased off, helping to stabilize prices. We still think the risk is high for any energy stocks other than our holdings of high yielding, steady producers of cash flows.

Natural gas, after reaching multi-year lows throughout the spring of 2020, has firmed up during the summer as tropical storm activity has limited offshore production. While low prices have limited production somewhat, the fundamentals of the sector still don't represent an attractive risk/reward opportunity.

Commodities/Precious Metals

Commodities, in general, are usually sensitive to changes in world economic activity, increasing in price when economies are stronger and generally dropping when economic activity eases. However, commodities have been more sensitive to supply/demand shocks around the Covid crisis and have reacted more strongly to the increased liquidity provided by worldwide central banks than worldwide economic weakness this spring. A chart of the Bloomberg Commodity Index (as represented by the exchange traded DJP pictured below) shows the weakness during early 2020 and the strength since bottoming in late April.

This index would have shown more strength, but the agricultural commodities have been very weak (due to bountiful worldwide supplies) dragging it down, while the metals, both the base metals (copper, nickel, zinc, etc.) and precious metals (gold, silver, etc.) have shown lots of strength, driving the index higher.

The precious metals complex was strong during the second quarter and has had a near historic powerful July performance. Our study from past quarters of the technical patterns of gold, as illustrated in the graph below, shows how gold has advanced, then consolidated its gains and then advanced again, in an ongoing pattern, over the past couple of years. The most recent advance, as illustrated by the strong weekly moves upward in late July, shows the growing demand for gold.

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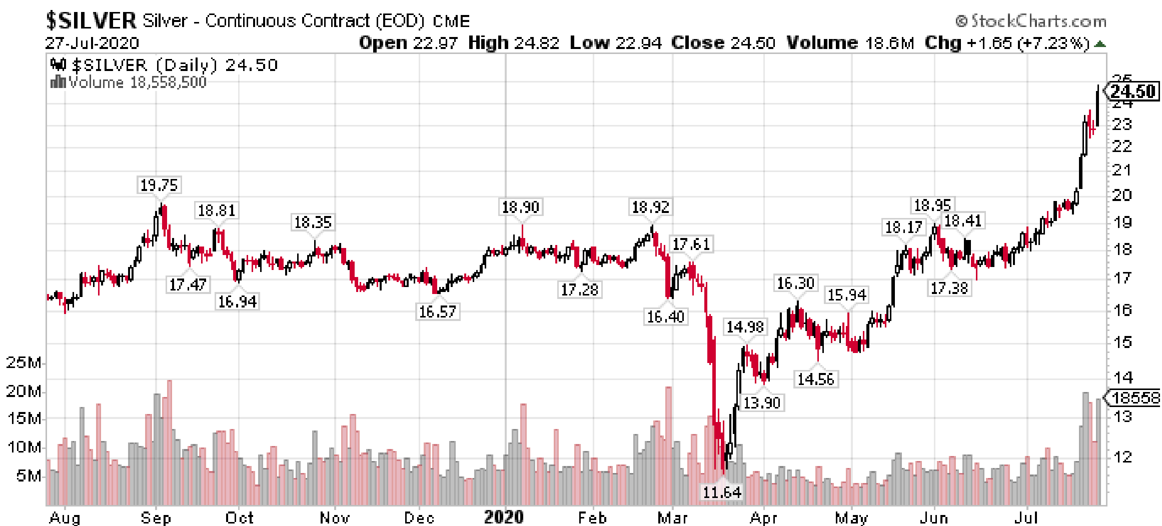
We thought last quarter that the consolidation seen during the April – early June period would again resolve itself upward; its had done so, and the weakening dollar has pushed it higher more quickly.

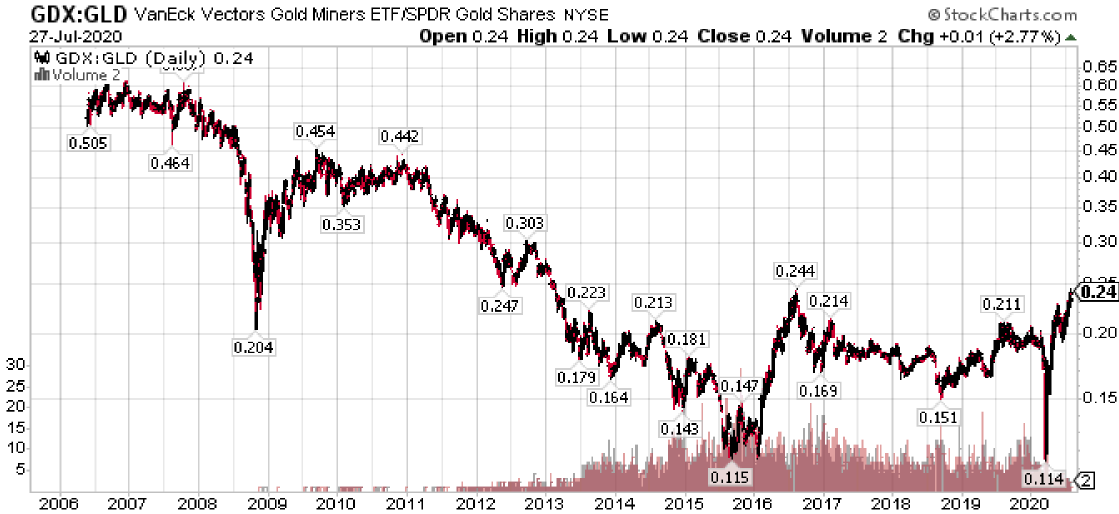
The laggard of the complex had been silver – it collapsed during the spring crash in financial markets but has bounced back strongly since then, with the July weakness in the dollar pushing up the price past the 2016 interim high. We think silver overcoming its technical resistance levels, with assists from a higher gold price and a falling dollar, will lead to silver's future outperformance to the upside.



Gold mining shares (as represented by the large gold miners ETF, Van Eck Gold Miners, symbol GDX) had underperformed gold since gold's peak in 2011; however, they have almost universally rallied strongly as gold set new all-time highs in July. The new bullishness in the mining shares has still not achieved prior valuations versus the gold price, but we expect the gold mining sector, especially the

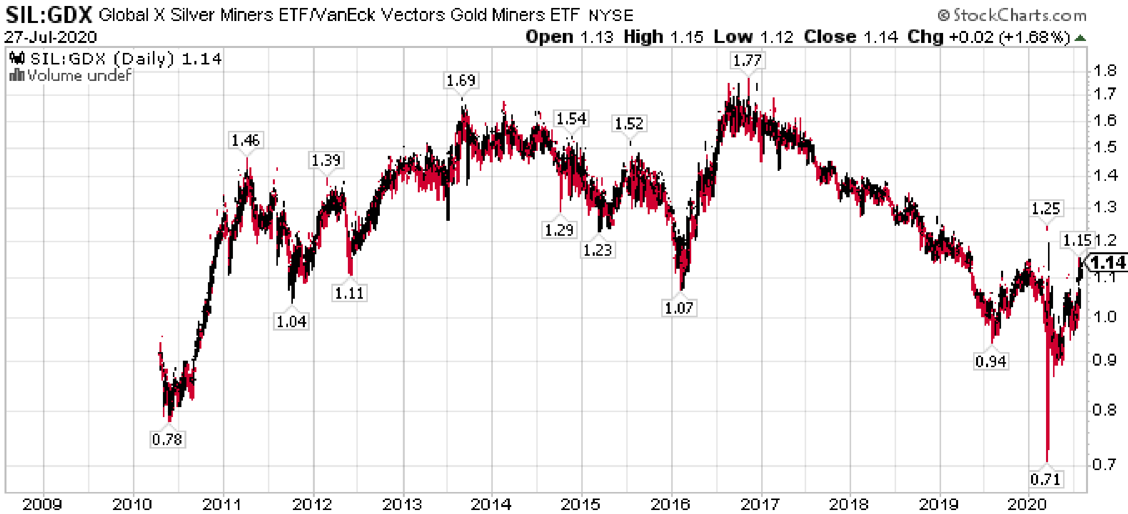
junior gold miners (which have underperformed the large miners), to continue to outperform gold. See the charts below which show the historical performance of both large and small gold mining companies, versus gold, as well as silver miners, versus gold mining companies (when the graph is falling, the metal is outperforming the miners; when the graph is rising in 2019/2020, the miners are outperforming):

Large miners vs. gold



Junior miners vs. gold

Silver miners vs. Large Gold miners (silver miners have underperformed from 2016 – early 2020)



As we highlighted last quarter: "The entire worldwide gold-mining industry is estimated to be currently valued at $400 billion, which is about three days of what the Fed just put into the financial markets or about 1/3 the size of Microsoft or less than 1/2 of the market cap of Apple." Technology stocks have been strong during much of 2020, but gold miners' recent price performances have been mostly stronger since the bottom of the Covid crash, as shown by the table on the following page, comparing GDX to the S&P 500. When the graph is upward sloping, the GDX Gold Miners ETF is outperforming the SPY S&P 500 index ETF, which it has done since has done since mid-February (except for the panic weakness of mid-March and a couple of weeks in May-June):

Gold has been strong against all other currencies, as worldwide central banks created more money and economic conditions have weakened. The US dollar has been the strongest currency heretofore, but gold finally reached an all-time high in US dollar terms on July 27th when it closed over $1,920/oz. The euro has recently been the strongest major currency, but gold has continued to make new highs when priced in all currencies around the world, as shown by the Gold (symbol $GOLD) versus Euro (symbol $XEU) chart:

Kanos Quarterly Commentary

Where Are We Now?

Everyone knows we have gone through 5+ months of historic upset, including economic, political and geopolitical events almost unimaginable only a few short months ago. While it is almost cliché, it brings to mind the classic quote, which has been attributed to Lenin:

> "There are decades where nothing happens; and there are weeks where decades happen."

We really are in that kind of period, with racially charged/social cause riots not seen since 1968, a crash reminiscent of 1987 and a brewing cold war that many thought we would never see after 1993. Still, we have had events happen over a short period not seen in decades, and that leaves everyone struggling to formulate where the world is, and where it is going, especially when it comes to one's investments.

We will not be able to answer where things are going based solely on judging events that have happened in 2020 due election uncertainties, etc. However, we do think we have enough examples of similar times that we can navigate the markets with some confidence, knowing the consequences of many past actions and how markets reacted to them in the past. While past isn't prologue to present as far as results are concerned, the past gives us many scenarios that have historically guided us successfully.

Year-To-Date

Stocks

So far during 2020, in the US stock market, we have had a decent start, a literal crash, a historic recovery and now a period of churn as market participants gauge the US and world economies, corporate results and forecasts for the future and the role of central banks in ongoing market dynamics. Graphically, the results for the first six months of 2020 look like the following chart of the three major indices:

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The above graph shows the Dow Jones Industrial Average ($INDU, black & red line) was down -9.55% in the first half, while the S&P 500 ($SPX, red line) was down -4.04% and the tech-heavy Nasdaq-100 (QQQ, green line) was up 16.92%, led mostly by a handful of super cap technology-oriented stocks. The performances have continued through July:

Bonds

Bonds have been as volatile as stocks at times, showing the rare market conditions in which we find ourselves. However, bonds have also been a source of some safety, rising when stocks were falling and retaining much or all of their value when stocks recovered. The following charts show the results:

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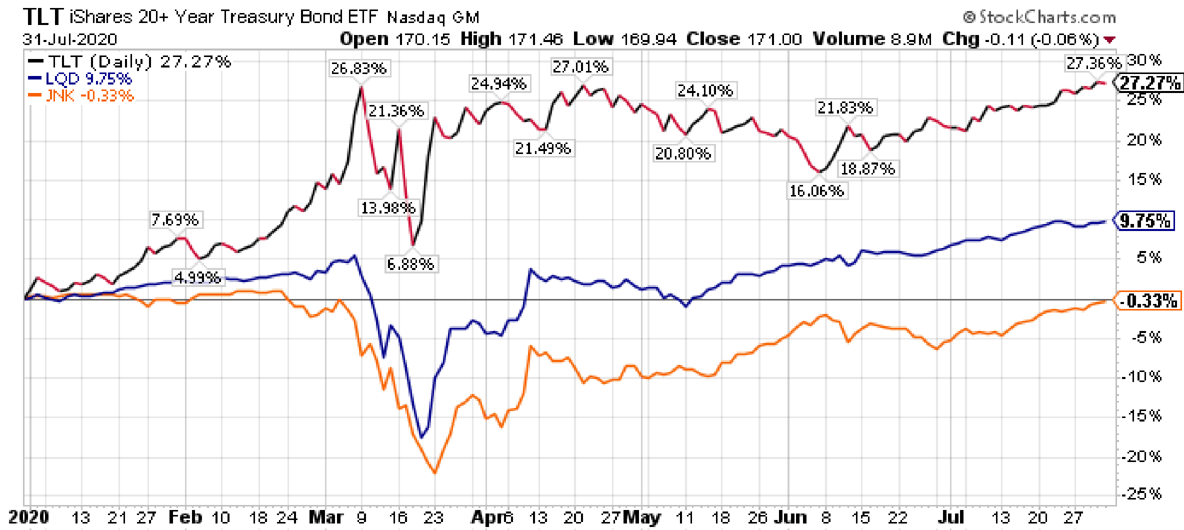
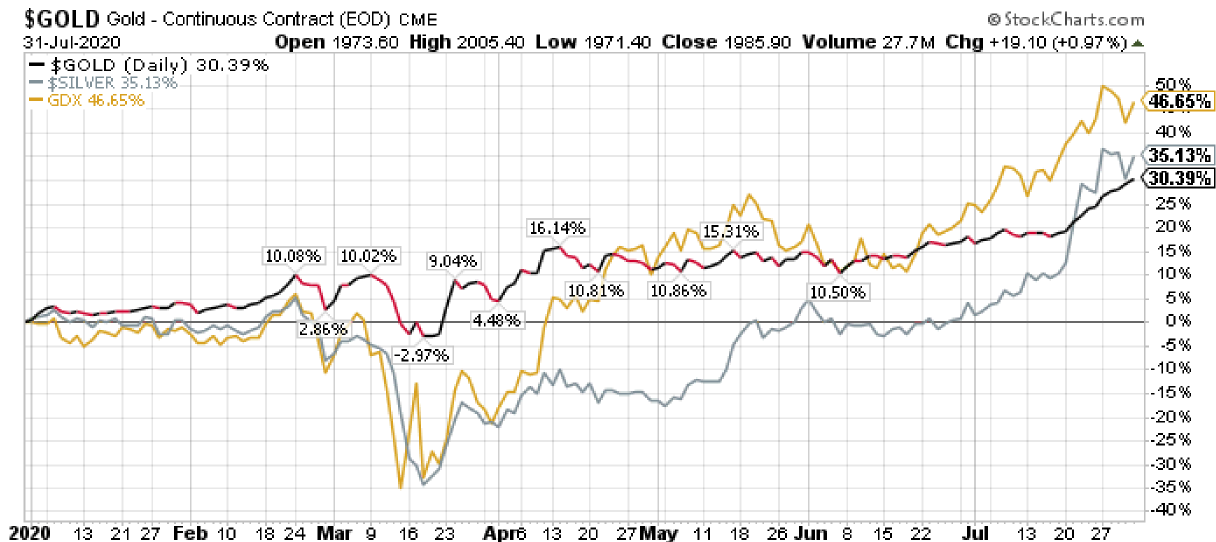


The chart shows that long-term Treasury bonds (TLT, red & black line) rose sharply as stocks started to sell off; even though a "panic into cash" occurred around March 23rd, the Fed's vow to buy bonds saved the bond and financial markets from further damage, pushing the gain on LT Treasuries back to a 20+% gain that sustains today. LQD, the blue line, represents investment-grade (IG) bonds; it shows that investors sold corporate bonds when the Covid scare ravaged company prospects, but when Treasuries were bought, IG bonds were also bought. The Fed started buying corporates in mid-April, causing the second "leg" upward. High-yield ("HY" or junk) bonds (represented by JNK, orange line) underperformed all the other bonds but moved on the Fed's buying Treasuries in March and corporate bonds (including some highly rated HY bonds) in mid-April.

Precious Metals

Gold has been the least volatile asset of all the major assets, although the liquidity scare of mid-March sent it down before a quick recovery.



The chart shows gold (the red & black line) up around 10%+ March–early June and rising since late June. Silver, much more volatile, is the silver line in the chart and was down YTD March – May but recovered to go positive and has gained +35% through July. The large gold mining stocks (including some large silver miners) are represented by the GDX ETF (gold line in the chart) which, after recovering from a mid-March pounding, has risen strongly to gain +46% through July.

Valuation

Most valuation metrics and comparisons to prior periods show that we are at a time of high valuations, which some would call bubble valuations and unsustainably high. However, we have the lowest interest rates in history, so higher valuations make sense when discounted by extremely low interest rates. Sustainability is the big question; the market has been arguably overvalued for months or even years, and yet the indices have sustained (and added to) levels of recent years, lessening the question of how long the market will stay elevated.

The following charts we believe will help frame some valuation parameters we think are illustrative:

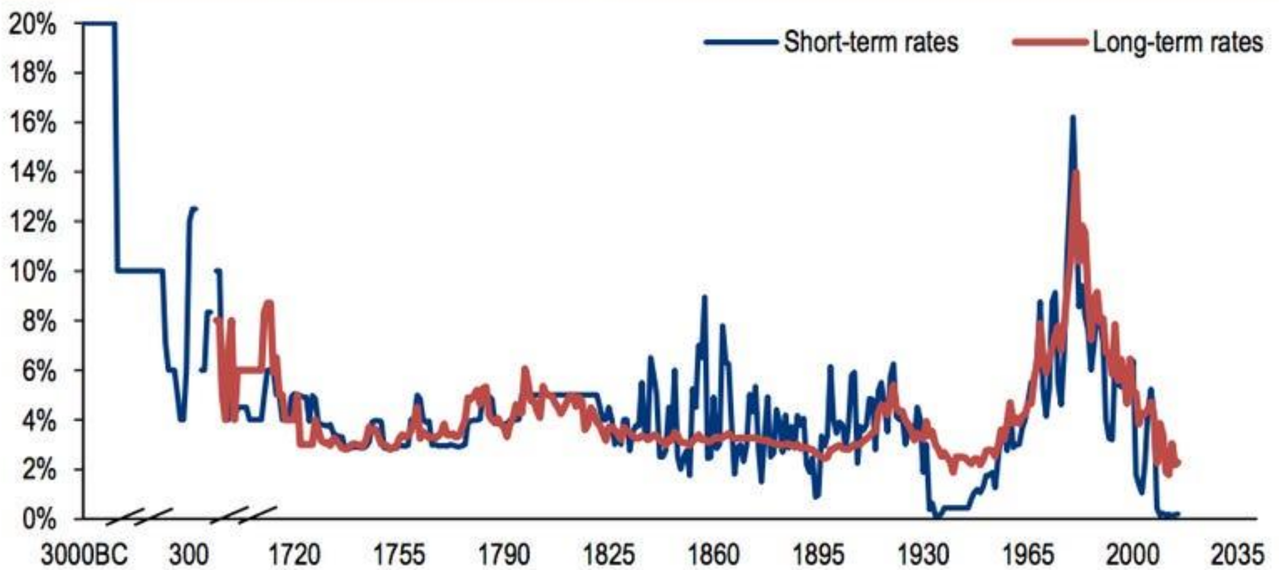
Nasdaq 100 / S&P 500

The Nasdaq 100 index represents the more speculative large stocks in the market, while the S&P 500 has traditionally represented a cross section of all the large US publicly traded companies.

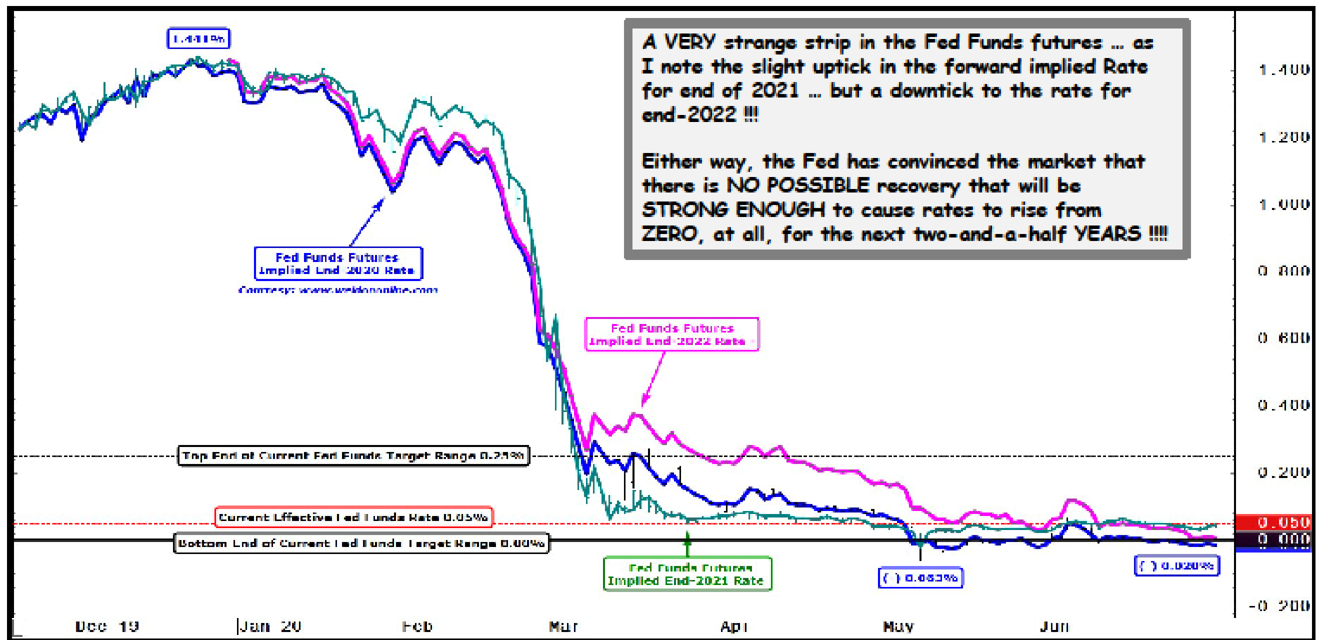
The above chart, from ZeroHedge article "Gundlach Says 'Classic Bear Market Rally' Reminds Him of 1999" 7/25/2020, shows the Nasdaq-100 as compared to the S&P 500; it has just now exceeded the previous high, achieved in early 2000 at the height of the Dotcom bubble. That is not good news.

Interest Rates

However, as mentioned above, stocks aren't as overvalued as 2000 (using discounting techniques) because interest rates are at 5000+ year lows (not a typo!). In the following chart from Bank of America Merrill's Andrew Harnett, interest rates have literally never been lower:

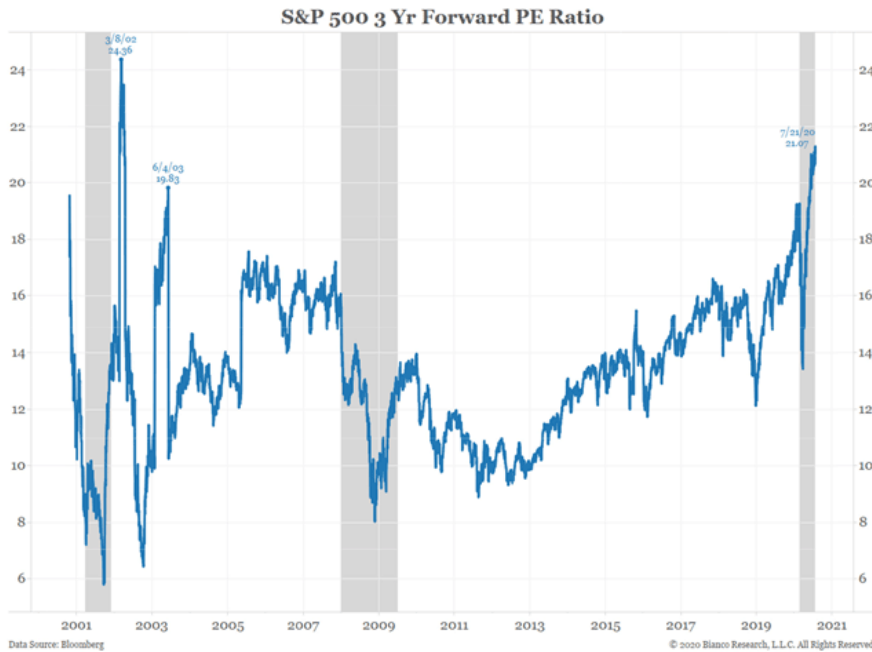


In addition, current interest rate futures markets price short-term US interest rates within 5 basis points of zero percent <u>through at least the end of 2022, so for 2 1/2+ years forward</u>. The following chart from Greg Weldon's 7/06/2020 Weldon Live presentation shows this:



While the graph is a little hard to make out, the Fed Funds futures curves for Dec 2020 (blue), Dec 2021 (green) and Dec 2022 (fuchsia) are graphed over time on the bottom (y-axis). As the Covid-19 chaos hit financial markets in March-April, all dropped rapidly, ending up near zero interest rates by May 2020. These graphs show the market is convinced that interest rates aren't going higher until at least 20203, meaning stocks can be discounted at near zero interest rates for longer, making equities less overvalued as they appear on the surface.

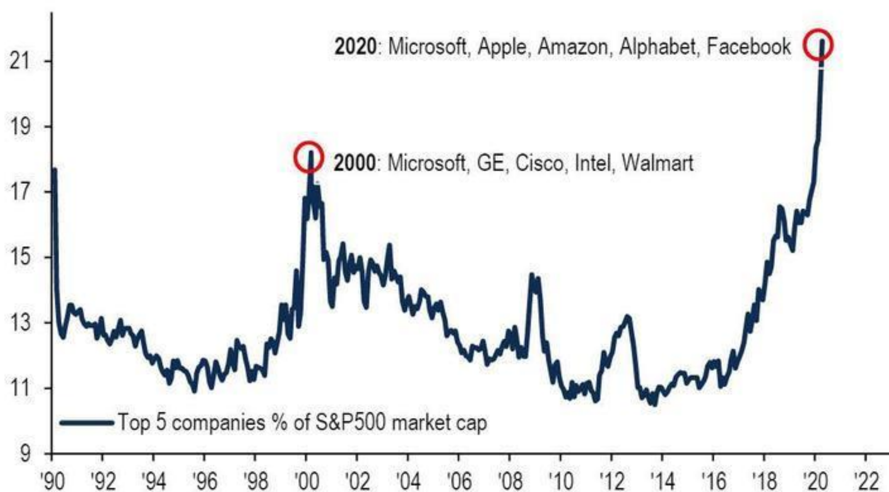
Valuations against earnings (the P/E ratio) are a commonly applied metric. In the next chart from a recent tweet from Jim Bianco at Bianco Research (using Bloomberg data), the forward S&P 500 P/E ratio (using estimated earnings for THREE years forward to try to eliminate all Covid effects) at 21.5x P/E is still high by historical standards, especially with earnings for the future so hard to estimate due to both economic and Covid unknowns. Like others shown earlier, this graph shows that valuations are elevated (2nd highest in history), while using some highly speculative earnings estimates. If these earnings are wrong, they are probably too high, meaning stocks might be even more overvalued than shown here:



Not all stocks have been rising, since a number of mega-cap stocks have grown so big over the years that the movement of a small group of these huge stocks influences indices more so these days. Two graphs show the influence of these mega-caps:

1) Bank of America has produced this chart that shows five stocks: Microsoft, Apple, Amazon, Alphabet and Facebook comprise the largest concentration of five stocks in the S&P 500 in history, even more than the largest five during the wildly-overvalued Dotcom bubble in 2000.

Chart 2: S&P500 now more concentrated in the 5 largest stocks than ever



Source: BofA Global Investment Strategy, Bloomberg

2) Deutsche Bank, using Bloomberg data, constructed a group of ten very large stocks, which added Visa, Mastercard, Nvidia, Netflix and Adobe to the above five stocks and showed that those 10 rose 35% through early July 2020, while the 490 other S&P 500 stocks in aggregate were still down more than 10% year-to-date:

S&P 500 mega-cap growth vs others (re-indexed, Dec 31 2019=100)

*MSFT, AAPL, AMZN, GOOGL, GOOG, FB, V, MA, NVDA, NFLX, ADBE

Source: Bloomberg Finance LP, DB Asset Allocation , DB Global Research

Who is buying these highly valued stocks, and why do they continue to buy? The easy two answers are these: 1) these mega-cap stocks, along with some smaller, high growth stocks, have continued to report growth in sales, and their stocks have continued to attract momentum investors; and 2) passive investing, investing money into indices without regard to valuations or asset selection, has grown to represent as much as **45%** of invested money in US stocks, meaning almost half of all investors are investing due to history (market capitalization) and not looking for attractive valuations.

Below is a graph of the Momentum exchange traded fund (MTUM) and its performance over the past few years:

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So, it appears that the mega-caps have been passively bought for the past few years due to their growth and momentum, propelling them to new highs but at incredibly high valuations. A major reason fundamental investors try to measure valuations is that they give a hint at future performance – on average, high valuations are much harder to sustain than lower valuations, when hiccups in earnings, natural disasters or economic downturns can affect stocks whose valuations demand perfection, much more so than those with lower valuations, where many investors expect that disappointments in earnings could happen.

Are there any subgroups of the S&P 500 that do not include those mega caps and are outperforming the S&P 500 index?

S&P 500 Healthcare vs. S&P 500 index

The chart above graphs XLV (Health Care ETF) versus the S&P 500 (when the line moves up, HC outperforms; when it moves down, the S&P 500 outperforms). The chart shows that Healthcare outperformed during the Covid crisis (big rise March-May) but gave back most of that outperformance by mid-June. However, it looks like healthcare has started to outperform again.

S&P 500 Materials vs. S&P 500 index

Materials have outperformed the S&P 500 index consistently since they underperformed during the Covid crisis (line slopes upward from the mid-March spike downward). This may be signaling inflation on its way, despite a so-far anemic recovery, because inflation is one support for Materials stocks.

S&P 500 Energy vs. S&P 500 index

After a horrible drop into March, energy outperformed for a couple of months but has fallen back.

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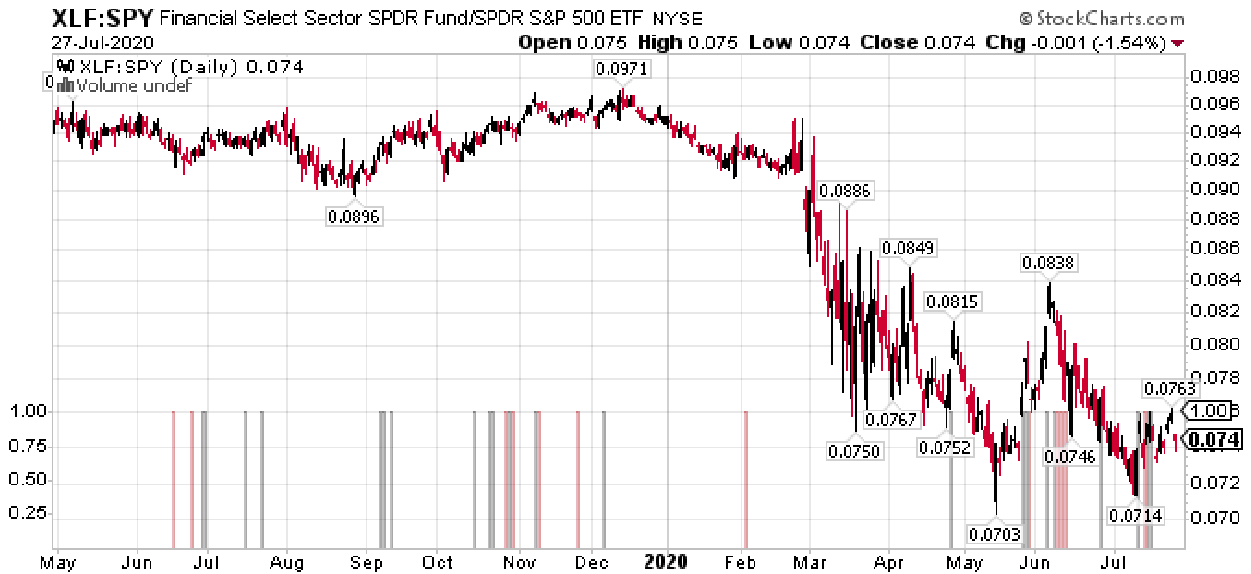
Utilities, Industrials and Consumer Staples have all underperformed but look like they may be turning.

XLU:SPY Utilities Select Sector SPDR Fund/SPDR S&P 500 ETF NYSE
27-Jul-2020 Open 0.187 High 0.187 Low 0.183 Close 0.184 Chg -0.004 (-1.93%)

XLI:SPY Industrial Select Sector SPDR Fund/SPDR S&P 500 ETF NYSE
27-Jul-2020 Open 0.222 High 0.224 Low 0.221 Close 0.223 Chg -0.001 (-0.31%)

XLP:SPY Consumer Staples Select Sector SPDR Fund/SPDR S&P 500 ETF NYSE
27-Jul-2020 Open 0.192 High 0.193 Low 0.192 Close 0.193 Chg -0.000 (-0.23%)

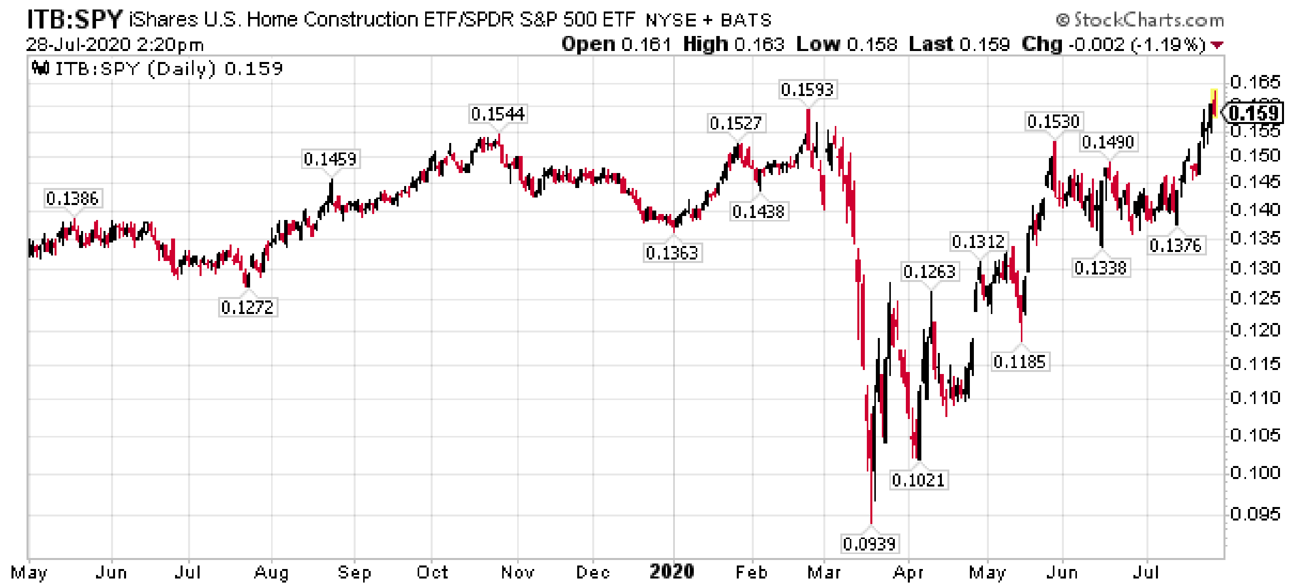
Financials and Real Estate have performed very poorly and don't seem to be recovering yet. Both charts are near the lows (they show the S&P 500 outperforming the sector) and aren't yet attractive.



Are there other sectors that look attractive on charts?

Precious metals, and more specifically, mining equities are attractive on the charts (as well as fundamentally). The GDX Gold miners are clearly outperforming the S&P 500 since mid- June. We already own gold miners but will look to add if attractive opportunities present themselves.

Homebuilders also appear attractive, as they have climbed back above pre-Covid levels versus the S&P 500 index. These are attractive, and we will look for opportunistic times to add ITB to portfolios.



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The worldwide interest in trying to find a Covid vaccine has led to renewed interest in the financing and development of more innovative medicines with biotechnology companies. Large biotech companies, as represented by the IBB Biotech ETF below, have seen much better performance versus the S&P 500 since the Covid crisis – so we are looking to add these stocks to our portfolios.

Summary

As shown in the pages of charts we have presented, the markets are highly valued but are buoyed by extremely low interest rates and an activist Fed, keeping investors in a risk-seeking mood. These conditions seem set to continue until the fall, when a still-struggling economy and a contentious political march to the November elections could lead to increased volatility in markets in the US and worldwide. Until then, the charts show us sectors and stocks that look attractive and some that are distinctly unattractive.

We still think that our portfolio composition of conservative stocks, Treasury bonds and a large dose of precious metals exposure favorably exposes us to appreciation while protecting the downside to a large extent, especially compared with US equity indices at risk for large downside corrections. We will continue to evaluate opportunities to increase the value of your portfolio while keeping a keen eye on risks affecting the financial markets.

The Managers of Kanos Capital Management
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