KANOS
CAPITAL MANAGEMENT, LLC

First Quarter 2014 Investor Letter

Portfolio Comments

Our portfolios performed well during the first three months of 2014. The first quarter marked the return of market fundamentals in helping determine asset valuations in the US. Some underperforming assets from 2013 have outperformed so far in 2014 (most notably gold and mining companies) as many low valuation assets improved in price and many "high fliers" experienced lower prices. The US Federal Reserve (the Fed) continued to taper its bond purchases during the quarter which we believe contributed to the sell-off in equities due to the return of higher risk premia. The heating up of geopolitical tensions around the Ukraine and Crimea situations also contributed to the uncertainty and market volatility.

First Quarter Market Conditions

January started off weakly with stock markets dropping the first week, then recovering slightly mid-month. In late January, poor earnings results and concern about valuations pushed stock markets to multi-month lows. The S&P 500 was down 3.46%, with Energy, Consumer Discretionary and Consumer Staples sectors suffering the largest declines. Utilities and Healthcare sectors were the only S&P 500 sectors that were up. In individual industries, gold mining shares (except for Newmont Mining) were strong during the month, leading US stock sectors. US Treasuries rallied on the weakness, with 10-year yields dropping from end-of-year multi-month highs over 3% to 2.6%. US high yield bonds rallied during the first part of January, but fell off in sympathy with stocks to end the month flat. Developed world bonds rallied, but emerging bonds fell, led down by international high yield, which dropped significantly. Emerging stock markets also fell precipitously, spooked by the Fed tapering its quantitative easing program and the drop in developed stock markets. Gold rose almost 2% for the month, but commodities in general, as represented by the Jefferies/Reuters CRB Index hit a multi-month low in mid-January and then rallied strongly into the end of the month. West Texas Intermediate (WTI) crude oil dropped to $90/bbl in mid-January, but then recovered to $99 by month's end.

Much of January's weakness was reversed in February as investors around the world judged future prospects to be brighter than previously thought. The US stock market bounced back, with the S&P 500 up 4.57%. The Materials, Consumer Discretionary and Healthcare (influenced strongly these days by large biotech stocks) sectors led the way higher, gaining in excess of 6%. The gold mining sector gained over 10%, its best performance in many months. Weaker S&P sectors included Telecoms (down 1% for the month), Utilities and Consumer Staples (collectively, the less risky sectors). Treasuries initially weakened during the month, with 10-year yields reaching 2.80% but then rallied to close flat for February. US high yield bonds zoomed higher with equities, compressing yields and spreads back to historical lows. Emerging stock, bond and high yield markets all

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recovered, although not as much as their US counterparts. Precious metals were strong, rising throughout the month, as was WTI oil, which closed February at multi-month highs above $105/bbl. The wider commodity basket of the Jefferies/Reuters CRB Index rose strongly throughout the month, closing at its highest level since mid-2012 due to the continued rise in food prices (inflation anyone?), along with higher energy and metals prices.

March was a much more muddled month with large divergences in market performances. Corn and wheat prices were the largest gainers in the financial markets for both March and the first quarter, showing the continuing rise in worldwide food prices. The broad Jefferies/Reuters CRB Index was the sixth best gainer in worldwide asset returns for the first quarter. Stock markets were much more uneven with many winners giving back some of their gains. Although the S&P 500 gained 0.80% for the month (and 1.81% for the first quarter), sector performances were less uniform. Telecoms, Utilities and Financials were up over 3% for March, while Consumer Discretionary and Healthcare sectors were down more than 2.5% for the month. Notably, "high fliers" and momentum favorites had poor performances during the month, with biotechs (represented by the Healthcare underperformance) and technology stocks (notably Tesla, Facebook, Netflix, etc.) showing some of the largest losses. US Treasuries seesawed during the month, but ended near their lows with a yield above 2.80%. US high yield dropped with the high flying equity weakness, but ended March almost unchanged. Unrest in the Ukraine and Russia affected global markets, with Western European stock markets the beneficiaries (especially the PIIGS countries!) gaining in price as capital fled to safer locales. As the situation cooled down in mid-to-late March, most foreign markets rallied strongly, leading to nice gains during the quarter; Greek and Portuguese stock markets were the biggest gainers for the quarter, along with UK and Spanish stock markets. Emerging market stock markets did well, as did emerging bond markets which were the seventh best performing asset during the month. Gold and WTI oil gave back some of February's gains, but gold was the seventh best asset performer during the quarter (closing around $1280/oz). WTI ended the quarter above $102/bbl. Notably during the month, the strong flow of US initial public offerings (IPOs) continued, especially those of lower quality than in recent months; the IPO of King Digital, creator of game app sensation Candy Crush, had a horrible debut, pricing poorly and trading down for three straight days.

Equities

A rocky first quarter for US stocks exposed some of the concerns over valuations and continued growth prospects in many sectors of the market. Emerging markets exhibited January weakness caused by the Fed's tapering of bond purchases, but the de-escalation of the Ukraine situation and anticipation of possible monetary stimulus from many central banks led to most world stock markets rallying into the end of the quarter. However, weakness in US high fliers and momentum stocks into April showed the uncertainty in the former leaders of the market from 2013. US corporate profit margins have continued to stay high, and if corporate earnings worldwide hold up, stock markets could continue to rise. However, geopolitics and the stalling out of housing and economic fundamentals have kept in check much of a rise in stock market indices into April.

Foreign equities, especially European equities and most notably those of Greece and Portugal, outperformed during the quarter, benefitting from the flight out of Eastern Europe due to unrest around the Ukraine and other former Soviet republics. Emerging markets recovered strongly and "frontier markets" such as Kuwait and Nigeria performed very, very well during the quarter. With European economic fundamentals weak and the uncertainty of the pace of growth in emerging and frontier markets, these outperformances smack of professional money managers looking further afield for less-discovered assets in which to invest money as more traditional markets cause concern due to weakening fundamentals and/or from high valuations. Thus, we would attribute these performances to reaching for performance, and we fear that these types of advances could reverse severely when and if more foreign capital is removed from investments in these smaller countries.

Precious Metals

Precious metals and especially precious metals mining companies rebounded strongly from a weak 2013 as investors realized the extreme undervaluation of the mining shares and recognized the fundamentals of rising money supply worldwide, rising inflation in more and more places and the continued investment by Asian countries in physical precious metals supplies. Most of the fundamentals that pointed toward a rise in precious metals prices at the beginning of 2014 are still in place; thus, the rise in gold prices in April and the concomitant rise in mining shares continues to be encouraging for a major concentration in our portfolios.

Energy

Energy markets continue to show both strong and weak fundamentals, leading to markets that are difficult to analyze. Brent Crude oil prices continue to trade at a premium to WTI oil in spite of its inferior quality, due to Libya's continued unrest and accompanying inability to export supplies. However, WTI crude was and is in backwardation, showing unexpectedly strong demand (backwardation, with current prices higher than future prices, is the result of high current demand) in spite of large stored supplies in North America. Gasoline prices have stayed elevated, despite flat-to-down US usage, due to high international demand. Furthermore, the "winter that would not end" continues to support US natural gas prices. This past winter used up so much stored natural gas that analysts aren't sure that enough gas can be stored to be full again for next winter. Meanwhile, US crude storage is at-or-near historical high levels, and worldwide economies are growing much more slowly than forecast just months ago, thus pointing toward less expected demand than forecast recently. We have maintained our energy investments, but we are nervous about any demand shocks that would lead to a sudden sharp decline in crude oil prices.

Bonds

So far, the effects of the Fed's tapering of bond purchases have been muted. US Treasuries have bounced between yields of 2.60% on the downside and 3.00% on the upside, showing at various times

the concern about stagnant economic conditions and the concern for lower bond demand (winding up of US quantitative easing) and signs of inflation. However, high yield bonds continue to show maximum complacency, assuming a very low default rate with spreads continuing to set new historical lows (yield on high-yield bonds are closer and closer to yields on comparable-maturity Treasuries). We continue to think that bonds are a poor long-term risk/reward situation, but they have not broken down during 2014, as many people thought they would. The long-bond (the 30-year Treasury bond) has been the best performing widely-owned bond, showing that there is still plenty of fears about deflationary pressures, with people willing to buy a bond that will yield less than 3.50% for the next thirty years.

Foreign bonds of all “stripes” did well during the quarter, again, mostly from a flight away from Eastern European investments. The fact that Spanish government bonds were the seventh best-performing asset class during the first quarter shows this “in spades;” while Spain’s fiscal situation has improved somewhat with its austerity measures taking hold, its growth prospects have not improved, thus providing only limited fundamental support for better prospects for Spanish bond holders. We anticipate a movement of poorer-rated bonds back toward their recent lows as inflation becomes more of a concern worldwide.

Other Markets

Japanese equities did poorly during the first quarter as economic growth stagnated from recent improvements and imports increased faster than exports. The Japanese economy was expected to accelerate temporarily in advance of the April 1st increase in consumption taxes, but Japanese equities did not perform well during the quarter, showing weak expected demand in spite of the tax hike. The Japanese yen strengthened a bit during January as people unwound positions financed by borrowing Japanese yen (investors who had borrowed yen to buy investments worldwide sold these and paid back their yen short, thus buying back yen and causing some temporary yen strength). We anticipate that worsening Japanese economic conditions will force the Bank of Japan to further weaken the yen; the market seems to agree with us, as the yen did not strengthen further even as markets faltered during the spring.

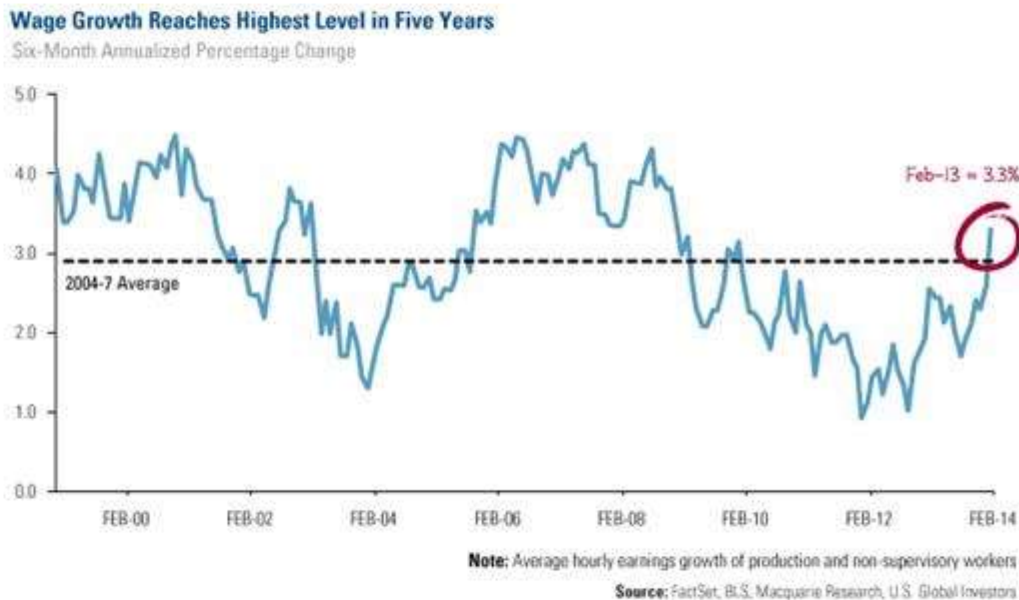
Going Forward

Economy

Economic statistics have continued to be uneven during March and April, showing economic stagnation, but have not been poor enough for the Fed to consider slowing or stopping their tapering. Meanwhile, the amount of monetary stimulus in the system continues to build, albeit at a slower pace with the tapering, meaning that any economic pick-up could cause that money to be put to work and stoke additional inflationary pressures.

While the financial press continues to downplay higher prices currently seen in the economy, we believe that these prices are already starting to take a toll, and that it is inevitable that inflation statistics will start to pick up these factors. One main cause of inflation is being signaled by the eighteen-month high in the Jefferies/Reuters CRB Index (the old Commodity Research Bureau broad index of commodities), led by the much higher prices of grains, as well as higher energy prices and higher metals prices. While economists usually try to exclude food and energy prices from inflation statistics due to their volatility, we believe their higher prices are affecting other inflation statistics and point toward higher inflation statistics readings that will finally show the inflation that has been building in our economy for a long time.

However, many economists dismiss talk of inflation **without a strong increase in the level of wages in the economy**. Unfortunately, it looks as though wage inflation is rearing its ugly head (see chart below from US Global Investors, as reprinted by ZeroHedge); wage growth is now accelerating faster than during the pre-financial crisis period. This condition will also be affected by President Obama's executive order raising minimum wages for government contractors as it goes into effect at the end of this year.



Equities

The first quarter showed less strength in US equity markets than during much of 2013. The weakness of many high fliers in the technology and healthcare/biotech sectors showed less confidence in the runaway bullish enthusiasm that was evident for much of last fall. Also, while the Fed is tapering its QE bond purchases, this is merely slowing the amount of monetary stimulus being forced into the banking system and is not a reliable indicator that the economy is ready to stand on its own again, much less achieve "escape velocity" (the ability for economic growth to accelerate without stimulus).

Thus, it seems like the US equity markets have not lost all the fuel that has boosted them over the past couple of years, and there is a good chance they continue higher during much of 2014. We believe there are many indicators that the markets as a whole are overvalued (historically high profit margins, historically high margin debt levels, high retail involvement in the stock markets, the highest number of IPOs of unprofitable companies since 2000 and ultra-low interest rates causing increasing misallocation of capital), but we also see the Fed standing at the ready in case of sudden market weakness to stop the taper which would probably serve to push people back into equities, judging by recent history. However, we believe our portfolios of lower valuation stocks and inflation beneficiaries will outperform the overall stock market going forward as risk management and runaway monetary stimulus further impacts investors in US equities. In our Kanos Quarterly Commentary below, we will discuss more of our thoughts on US equities.

The outlook for foreign equities seems to differ widely by geography. European stocks, in spite of weak economies continent-wide, continue to be strong during 2014, and many European markets led performance statistics for worldwide results during the first quarter. We were surprised by the outperformance, thinking that stagnant economic conditions and continued austerity in southern European nations would temper investment gains. However, low valuations, decent yields, and the flight to Western European safety and out of Eastern Europe/Russian investments all drove investment dollars to Western Europe. We believe this outperformance will not last as economies suffer from higher energy costs and political uncertainties around the Russia/Ukraine confrontations. Financial news continues to ramp up the probability that the ECB will resort to some kind of quantitative easing. If this happens, Western European stocks will probably rally some more, but as with the US, economic fundamentals will almost certainly re-assert themselves, causing European equities to weaken afterward (in the medium term, at least).

Japanese equities have had a worse 2014 than they did during 2013, but we believe Prime Minister Abe will force the Bank of Japan to loosen monetary policy further in order to counteract the consumption tax increase that occurred at the beginning of April. Further stimulus should boost equities and weaken the yen, helping our positions in yen-hedged Japanese equities.

Other Asian (non-Japan) equities have had a decent 2014, and we expect continued worldwide monetary stimulus to flow in large part to Asia where investors continue to see economic growth with less political volatility. We will be looking at ways to increase our exposure in a risk-adjusted way.

South American equities, led by Brazil, rallied during early 2014. Brazilian equities rallied after a multi-year bear market in which investors lost more and more confidence in President Roussef's policies. Now the speculation is that she may be on her way out, and Brazilian stocks, led by mega-caps Vale and Petrobras, have recovered some of their 2013 losses. We are not as comfortable with betting on Latin American political outcomes and have been burned by value traps like Petrobras in the past. Thus, we will be investing very carefully if these types of situations start to look even more attractive.

Precious Metals

In last quarter's letter, we made the case that gold was in a place that was extremely favorable to resume rallying after a 2+ year bear market phase. We said the following and listed the following reasons:

> ***"The setup for precious metals prices finally seems to have bottomed out and looks set to improve after a dreadful performance in 2013. There are a number of reasons for optimism in regard to rising gold prices going forward:***
>
> 1. ***Large banks are long***
> 2. ***Technical factors***
> 3. ***GOFO has been negative for much of the last few weeks***
> 4. ***Chinese imports through Hong Kong continue at historically high levels; Comex stocks are at very low levels***
> 5. ***Monetary stimulus around the world continues***
> 6. ***Mining companies are at historically low valuations…"***

Gold and mining stocks have rallied in 2014, and remarkably (in spite of the rally), all the above reasons still prevail, making the environment even more attractive as investors, sustaining losses in other parts of their equity portfolios, look for attractively-valued stocks that have upward momentum. Mining stocks are still over 40% undervalued by some of the analysts we follow (on post-2009 trading valuations ranges and compared to the underlying metals prices); thus, we believe there is still a lot of room for price appreciation in the stocks as well as in the metals themselves. For the first time in many months, we can say that about our mining stock portion of our portfolios and continue to be extremely bullish toward these stocks due to fundamentals, technicals and economic backdrops.

Energy

The energy markets remain an enigma due to huge conflicting fundamentals and very little movement in prices, especially in crude oil. Prices of both WTI and Brent crude oil remain above $100/bbl, and the futures price curves of both grades is in backwardation, showing that crude for present delivery is more valuable than future delivery – a symptom of good demand. Meanwhile, inventories of crude oil in the US are at an all-time high, and year-over-year, the US demand for gasoline has fallen, both of which would normally signal weak market demand. Brent is generally an indicator of world crude prices, and it continues to trade at a premium to higher-grade WTI, showing higher world or non-US demand. Yet, Libyan crude supplies, held off the market by tribal unrest and the capture/shutdown of most of the large crude export terminals there, are expected to come back to world markets as negotiations between the Libyan factions have improved lately. The embargo against Iranian crude has not been as effective as the US would have liked (leading to more Iranian exports), and Iraqi crude supplies and exports have grown to be the highest in many years. Thus, worldwide supplies appear to be plentiful, and deliverability is growing and is about to grow faster (when Libya returns). Yet, prices stay high, and energy equities (which in most cases have been undervalued due to all the

abovementioned uncertainty) have rallied. We have maintained our energy investments but have been concerned about adding to them before any weakness in oil prices. Were crude oil prices to drop, we would be more attracted to increasing our exposure to energy equities (at attractive valuations).

Natural gas has been a different story, as the "winter that would not end" seems to have finally ended in April. US natural gas prices have leveled-off despite stored supplies having fallen to multi-year lows due to production picking up in shale formations around the US. Energy equities with large natural gas exposure have rallied as natural gas is no longer considered a negative. We believe the large amount of already-drilled natgas wells (being completed as prices stay above the $4/MMBtu level) will put a near-term ceiling on prices, and only when it is determined how much gas will be stored (and used) during the summer will prices re-adjust for the longer term. We believe that may happen in mid-summer. If supply/demand fundamentals prove attractive, we could return to natural gas-oriented energy equities during 2014.

Other Markets

The bond markets are the big keys to the world financial markets – they are much larger than equity markets and are considered to reflect the views of the "smartest participants" in the financial markets. However, at times, we believe even the bond markets "act crazy". Now is one of those times – as we write this in mid-April, Spanish 5-year bonds yield less than US Treasury 5-year bonds. **Read that again – over-extended, depressionary-economy Spain, the largest poster child for European real estate speculation and over-leveraging, now has sovereign bonds that are higher in price, lower in yield than comparable US Treasuries.** It seems to us this must be happening because the Fed is lowering its purchases of bonds while the ECB is expected to start buying European sovereign bonds, with the five-year maturities being the "sweet spot" for purchases. On straight fundamentals, however, this is the bond markets "standing on their heads".

We believe bond markets will continue to be bumpy, rallying at times during uneven, stagnant economic conditions (barely showing any growth) and falling when higher inflation concerns surface. Throw in the fact that monetary authorities worldwide are in various states of bond buying, and many see more to come (while currently there appears to be less to come), and there should be continued volatility in world bond markets.

Depending on how events unfold, we could have more flight-to-safety buying if the Russian/Ukrainian situation worsens. That situation could also lead to inflationary pressures (higher agricultural costs due to uncertainty of Ukrainian supplies, possible higher energy costs due to possible Russian interruptions of deliveries to Europe, etc.), so the situation continues to add extra uncertainty.

We see longer-term interest rates continuing to be low in the short-term as we see stagnant economic conditions and flight-to-safety buying trumping inflation concerns during 2014 at least. However, we think that the pressure for higher interest rates continues to build behind the scenes, and we could see

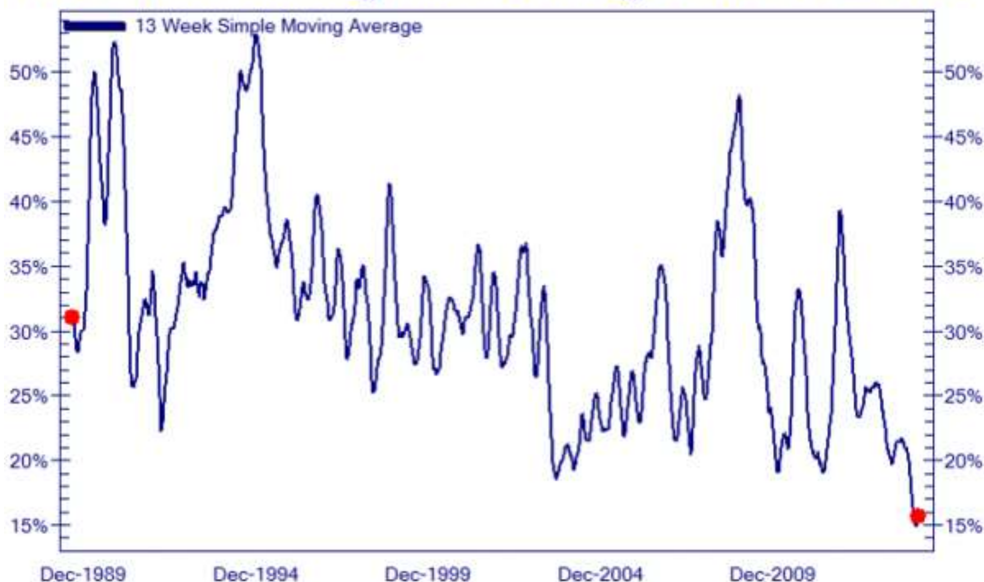
a large, quick rise in interest rates this fall or in 2015 if geopolitical concerns recede or there is any substantial pickup in economic activity anywhere in the world.

Kanos Quarterly Commentary

Stock markets have rallied strongly in the past couple of years, much of the time in direct contrast to economic fundamentals underlying world economies. Many pundits, including us, attribute this outperformance to ultra-easy monetary policies which have boosted monetary stocks, which have found their way into world stock markets.

However, 2014 has exhibited much more choppy performances by world markets. While the bull market appears to still be in effect, there are a number of growing concerns that are starting to add up to what we often see at market tops.

1. **<u>Percentage of Bears in the Market</u>** – many people consider the amount of bears as a good contrary indicator; if there are so many bulls (and thus very few bears), there is no one left to buy stocks and keep the rally going. The following chart displayed on ZeroHedge on 3/6/14 shows that bears are the lowest in decades (only 15%, compared to prior lows around 20%).

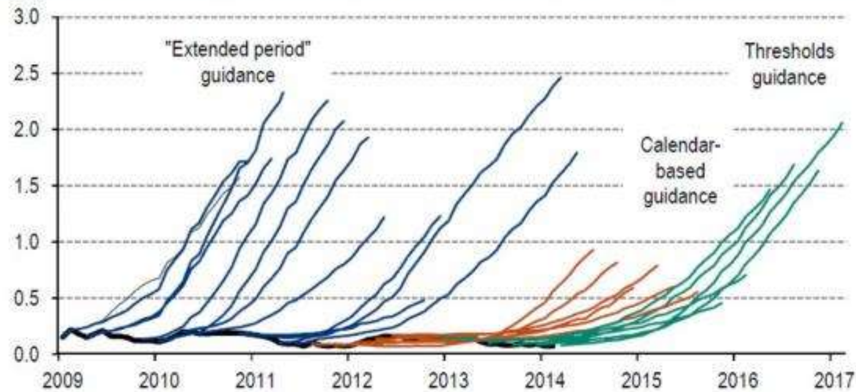


We believe that stock markets must be very near their ultimate highs if "everyone" is bullish and already in the markets. This extreme reading is a major concern

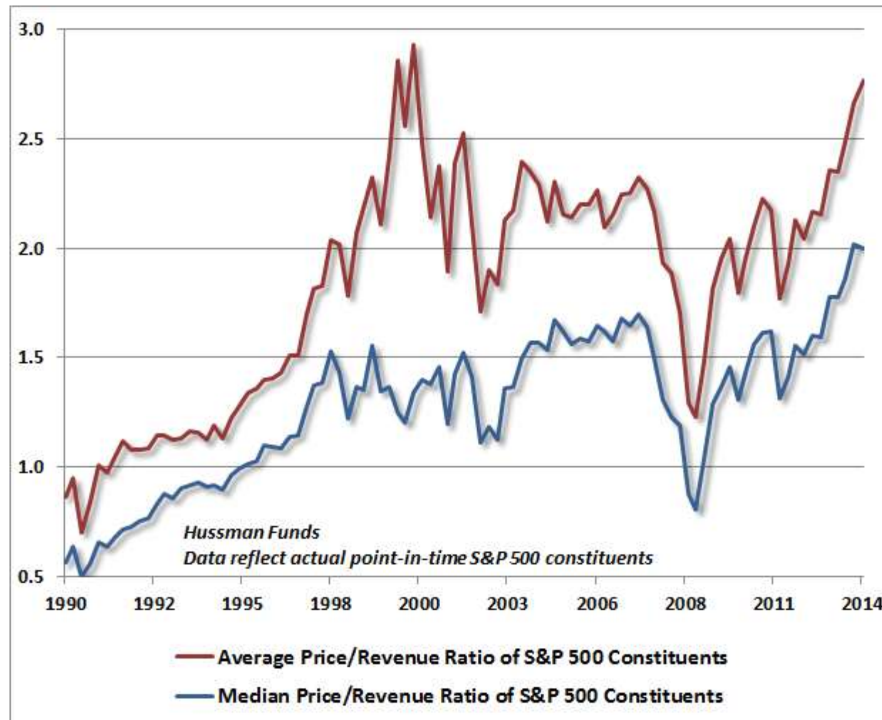
2. **The Amount of Unprofitable IPOs Going Public** – during the late stages of bull moves, there is usually a big appetite for IPOs, and near market tops, this IPO appetite has generally extended to companies that don't even have earnings yet; i.e. unprofitable IPOs. In the 4/7/14 issue of SentimenTrader, the level of unprofitable IPOs is shown (in the chart below) to be the second highest in history (only behind the Nasdaq mania of 1998-2000).

3. **The Amount of Leveraged Loans has Skyrocketed** – the artificially low interest rates caused by the Fed's monetary policy have caused more and more investors to reach for yields. As defaults have fallen way off and easy money is still available, poorer and poorer quality borrowers have been able to come to market and sell debt to yield-hungry high yield mutual funds that have had money pour into them over the past three years. The 3/12/14 issue of SentimenTrader shows (in the chart below) how the amount of leveraged loan issuance has truly gone skyward, far in excess of the amount of LBO debt issued in the 2006-2008 period. High-yield bonds have performed in line with the equity markets in the last couple of years, rallying to all–time low spreads to Treasuries.

4. **<u>Economists are Universally Optimistic about the Economy</u>** – The most recent survey of economists by National Association of Business Economists showed that <u>all seventy-two economists forecast an expansion of the US economy in 2014</u>. This type of forecasting unanimity usually occurs when trends have been extended and naysayers have been punished by the marketplace for negative forecasts in the past. Especially with such anemic growth in the economy in 2013 and early 2014, any shock to the economic system could easily lead to economic contraction, regardless of how the Fed tries to mitigate the situation. Another example of the poor forecasting ability of economists is the Fed's forecasting history. The Fed has not exactly been the best economic forecaster: the below chart, displayed on ZeroHedge on 4/25/2014 and assembled by Bank of America Merrill Lynch, shows the Fed's forecasts for short-term rates. The first lines in 2009 showed the Fed expected growth to take the Fed Funds rate back above 2.0% by 2011. The latest (green) lines show rates still stuck near 0% and not expected to rise past 0.5% **<u>until 2016.</u>** The Fed has missed growth forecasts badly for five years (and counting)!



5. **<u>Valuations Are Stretched by Many Different Methodologies</u>** – while this has been an ongoing point in our letters recently, we have found another worrying metric: Price/Revenue. We generally have ignored price/revenue or price/sales metrics because we didn't think they gave us enough evidence of the value of profitability of a company. But in John Hussman's April 28 article "The Future Is Now," Hussman highlights that price/earnings studies must be used in conjunction with current profitability levels, and are best used when the company's profit margin can be expected to stay at measured levels for a number of years. His company uses a number of tools to judge valuations, and his 4/28 column highlights price/revenue. Hussman's study, shown in graphical form below, shows median S&P 500 Price/Revenue is more than 30% higher than during the tech boom of 2000. This shows a much broader overvaluation today because much of the craziness was confined to the tech darlings of the Nasdaq in 2000 (many of which never made it to the much more diversified S&P 500) while many S&P non-tech stocks were shunned in 2000. Now, many more stocks show the highest valuations in history as measured by the Price/Revenue metric. This is also a serious concern.



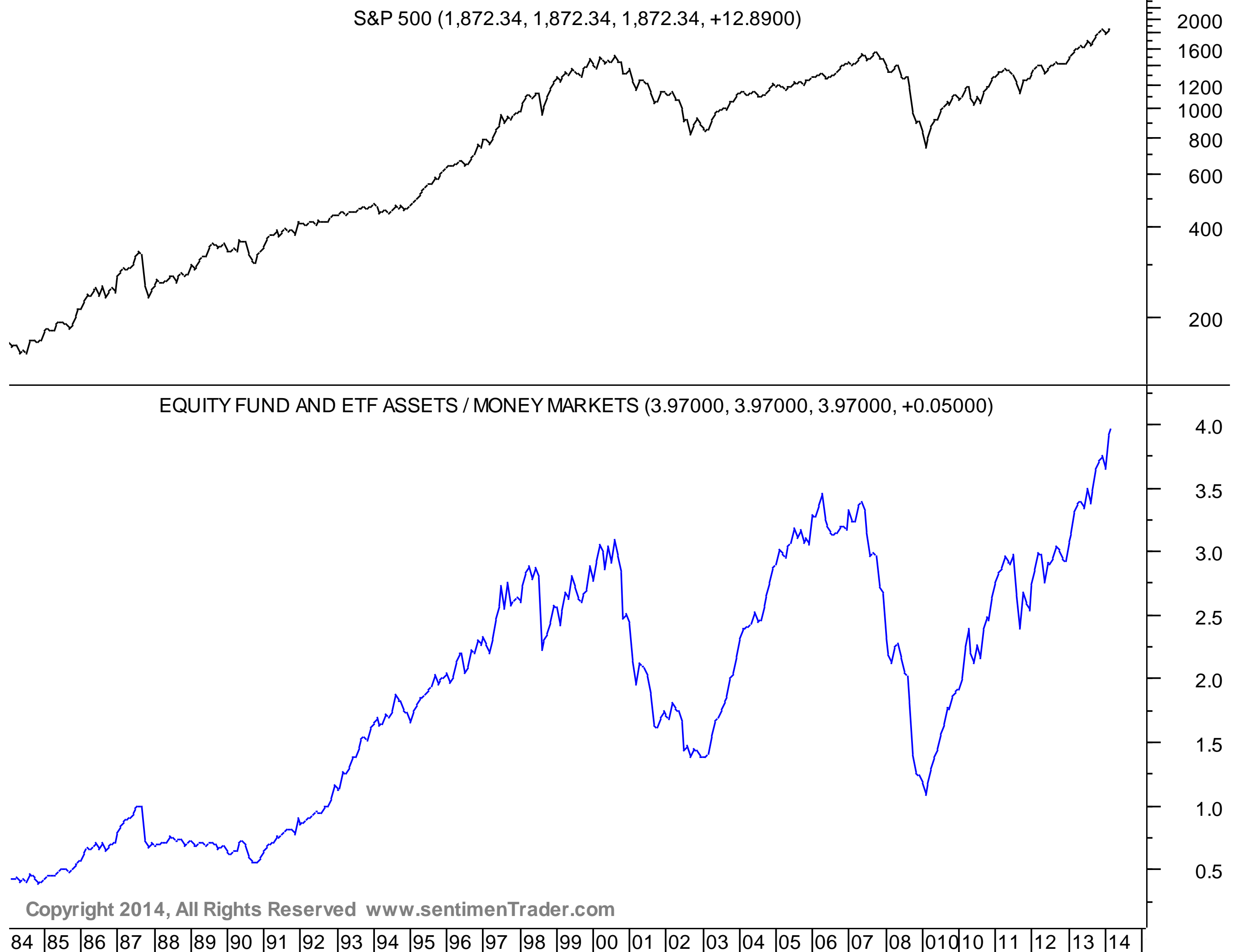
We at Kanos did a study in April to gauge valuation parameters in the US stock markets by looking at the top ten stocks in the Nasdaq 100 index and the Dow Jones Industrial Average, two indices which have lagged the recent outperformance by the Russell 2000 index (which includes many smaller stocks, the majority of which have outperformed mega-caps) or high yield bonds.

In an equally-weighted comparison, the abovementioned mega-cap companies still exhibit worrying levels of overvaluation. The most traditional measure of valuation, trailing price/earnings ratio, is an above-average 15.5x (both the median and the mean) for the 10 Dow stocks but a worrying 20.3x (median) and 81.8x (mean) for the 10 Nasdaq stocks, influenced by Amazon's 550x and Facebook's 101x P/E ratios.

The price/revenue ratio (P/R), highlighted in the sections above, should be higher than the market's P/R ratio due to the mega-caps high barriers-to-competition and long-established businesses. However, even with that caveat, they are still historically quite high. The 10 Dow stocks have a median P/R ratio of 2.1x (and a mean ratio of 2.3x), but the 10 Nasdaq had a median 3.4x P/R (with a mean of 5.7x). While these companies have been extremely successful (Apple, Google, Microsoft, etc.), the inevitability of technological advances and the obsolescence of older technologies points to these companies showing extreme overvaluation in terms of their P/R ratios.

6. **"Cash on the Sidelines" is at a multi-decade low** – the ratio of equity mutual fund and exchange traded funds to the amount of cash in money market funds, **currently at 4.0-to-1**, is far higher than it was around the last two market highs in August 2000 (3.1-to-1 ratio) and May 2007 (3.4-to-1 ratio), according to data compiled by SentimenTrader on 4/30/2014. The implication is that

there is very little cash earmarked for the stock market that is not currently invested; again, a very concerning circumstance.



In summary, we are concerned about these signals of overvaluation (and others). We believe that our low-valuation approach and willingness to own many currently out-of-favor positions give us a margin of safety in the event of market declines. These concerns make us hesitant to commit large amounts of your capital to new positions with high exposure to overall market moves.

The Managers of Kanos Capital Management

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