KANOS
CAPITAL MANAGEMENT, LLC

Second Quarter 2016 Investor Letter

Portfolio Comments

The second quarter was characterized by weakening economic conditions, easier monetary stances by central banks and rising commodity prices. Thus, our natural resource holdings outperformed, especially gold miners. Our long-term Treasury positions benefitted from slowing economic growth, and our defensive large-cap US stocks performed better than US stock indices. All-in-all, the portfolios performed well, with our small hedge positions the only categorical underperformer. We anticipated uncertainty during the quarter, so the effects of the Brexit vote were positive for our portfolios, especially our short euro positions.

Second Quarter Market Conditions

In April, crude oil was the big winner for the month, with West Texas Intermediate (WTI) crude rising 20% to end the month at $45.92. Equity markets, however, decoupled from the crude markets, failing to rise appreciably. US equity markets started April slowly, rose during the middle of the month, but a late month swoon took equity indices back toward unchanged, leaving only small gains. The S&P 500 was up just 0.39%, the Dow Jones Industrial Average gained just over 0.50%, while the Nasdaq Composite fell almost 2%, led down by earnings disappointments in a number of companies, most notably Apple and Microsoft. The Energy, Materials, Financials and Healthcare sectors had good gains in April, while Technology, Utilities and Telecoms were down the most. European stocks outpaced US stocks, with the European Stoxx 600 up 1.2% for the month. In other markets, gold was a big winner during the month, rising 4.5% and ending at 1,289.20/oz, while silver gained 15.4% to end April at $17.89/oz; mining stocks were also up strongly. Bonds retreated slightly during April with the yield on the 10-year US Treasury ending at 1.821%.

May was a stronger month for most markets: The S&P 500 rose 1.8% (including dividends), and the Nasdaq rose 3.6%. Technology led the way higher, rising 5.6%, while the Healthcare, Financial and Utility sectors were also up strongly. Laggards in May were Energy, Industrial and Materials. WTI crude oil was up another 6.9% in May, helping fuel stock market recoveries around the world, although US production didn't fall much, causing US energy stocks to fall slightly during the month. The European Stoxx 600 gained 1.7%, its best monthly performance since November 2015. Other international indices that gained include the Japanese Nikkei (+3.4%) and the Australian All Ordinaries (+2.4%). Bonds were roughly unchanged in May throughout the developed world, with only emerging market bonds showing losses. The US 10-year Treasury ended the month at 1.834%. Precious metals were the big losers during the month, correcting from their powerhouse performance

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earlier in the year: gold was -5.8% while silver was down 10% for the month. Currencies showed some movement, with the yen falling approximately 3% versus the dollar while the euro fell about half that amount.

June was a month dominated by unusual events. First, the jobs report printed a dismal +38,000 gain, far below even the most pessimistic of forecasts (with prior months revised lower also). This set the stage for the mid-June Federal Reserve Open Market Committee (FOMC) meeting where the Fed members lowered their economic forecasts radically and Fed Chair Janet Yellen all but admitted they didn't know where the economy was headed and wouldn't be raising rates. A couple of days later, St. Louis Fed President James Bullard admitted he'd lowered his forecasts to include virtually no more tightening and was suspending intermediate and long-range forecasting, a stunning admission of a lack of forecasting ability, especially from a former hawkishly-leaning long-time Fed insider. Finally, of course, the British electorate decided to tell their leaders to exit the increasingly bureaucratic and economically moribund European Union, which sent financial markets thrashing about violently toward the end of the month. The S&P 500 ended up with a 0.26% gain for June, led by strong performances in the Telecom, Utility and Consumer Staples sectors. Financials, Technology and Materials were down for the month. Worldwide, most indices were flat or had losses during June, highlighted by European banks, which fell 18%. Bonds benefitted from the offloading of risk, with US Treasury bonds soaring (and yields falling). The 10-year Treasury ended the month at 1.492%, having traded near 1.43% in the aftermath of the Brexit vote. Corporate bonds also rose. Precious metals reestablished their upward momentum, with gold rising 9%, silver rising 17%, and mining stocks having a very good month. Crude oil seesawed in price during June, ending down slightly as Brexit/slowdown fears and $50/bbl prices moderated more gains. Currencies took center stage during the latter part of June, highlighted by the British Pound, which rose going into the Brexit vote and plunged afterward, ending down 8%. The US dollar was flat overall for June, although that masked the real moves: the yen rose 7%, while the euro rose 0.4%.

Equities

In the second quarter, equities around the world had a mixed performance, with stocks in the Americas and southern Asia rising, while equities in Europe and eastern Asia fell. The S&P 500 was up 2.46% during the quarter, led by gains in the Energy, Utilities, Telecom and Healthcare sectors. The Technology and Consumer Discretionary sectors were the only losers for the quarter. The best performing stock markets in the world were recovering Latin American countries, Peru and Argentina, which both had gains of more than 12%. The worst performers were weak Europeans, Poland and Italy, which both lost more than -10% for the quarter. Most non-American developed markets were down, with Japan dropping -7.4%, Germany dropping -4.6% and China down -1.7%, although the UK rose 4.0% (all results in local currencies).

Year-to-date, the S&P 500 is up 3.84%, although the sector results show far more dispersion in results: Utilities +24.0%, Telecom +21.8% and Energy +14.3% (the gold miners were the best performing subsector – see below), while Financials were -4.1%, Technology was -0.32% and Consumer Discretionary was -0.1%. Internationally, the Americas produced the winners: Brazil's

Bovespa +18.9%, Canada's TSX Composite +8.1% and Mexico's IPC All-Share +7.0%, with all results in local currencies. The worst performers were in Europe and East Asia: Italy's FTSE MIB was -24.4%, Spain's IBEX 35 -14.5%, Germany's DAX -9.9% and France's CAC 40 -8.6%, while the Japan's Nikkei was -18.2% and the Shanghai Composite -17.2%. All-in-all, it was a poor first half showing for worldwide equities, with defensive sectors and "downtrodden" markets performing well and riskier assets weakening.

Precious Metals

Precious metals had another very successful quarter, as more dovish monetary policy directives came out in April and again around the June jobs report and subsequent FOMC meeting (as well as around Brexit). Gold rose 8.3% during the quarter, while silver outperformed almost all assets, rising 22% for the quarter. The rising gold price helped the sentiment and profitability of the precious metal miners, which rose 37.7% for the quarter, as measured by the Van Eck Gold Miners ETF performance. Brexit fears and the realization of more uncertainty after the actual vote propelled the metals higher into the end of the quarter (and the start of the third quarter). With more and more central banks uncertain over policy and leaning toward increasing dovishness in the face of economic slowing growth, the precious metals have been a prime investment for those seeking safety and a shield against expected increasing inflationary pressures.

Year-to-date, the precious metals have been the big winners, with silver rising 34.9% (second largest rise during the quarter, only trailing Lean Hogs' 39.3% rise) and gold rising 24.6%, both reaching levels not seen since 2014. Precious metals mining stocks were also the best performers in the US, as represented by the Van Eck Gold Miners ETF which rose 106.17% (before dividends).

Energy

Energy prices rose strongly during the quarter, buoyed by production outages, lower US production and rig counts and rising demand worldwide. WTI crude oil was the strongest gainer of any asset during the quarter, rising 26%, while Brent crude rose 19%. Energy stocks followed commodity prices higher, although not as strongly: the S&P Energy sector index was up 11.62% for the quarter.

Year-to-date, energy commodities were huge outperformers, with WTI crude rising 30.5% (that includes a precipitous fall in January/early February 2016) through June 30th, followed closely by natural gas, which is +25.1% YTD. Gasoline, while trailing the raw commodities in price, has still risen 18.1% year-to-date. Energy stocks obviously benefitted; after plunging through the first six weeks of the year, the S&P Energy stock index was up 16.10% (including dividends) in the first half of the year.

Bonds

Bonds performed well during the quarter, as weakening economies and worries over political turmoil drove investors to fixed income. As risk lessened (pre-Brexit), US high yield and investment grade bonds were up an average of +3-5% during the quarter, while long-term US Treasuries gained ~3%. British Gilts and German Bunds were the best gainers in Europe, gaining 5% and 2%, respectively. European corporates and high yield bonds were small gainers for the quarter.

Year-to-date, bonds have outperformed all major equity indices, with interest received plus capital gains giving very attractive total returns (in spite of historically low yields). Long-term US Treasury bonds, as represented by the iShares 20+ year Treasury ETF, were the best performers, rising 15.74% in the first half. US high yield has outperformed all but long-term sovereign bonds, with the US High Yield Index rising 8.7% year-to-date. Medium term (7-10 year) bonds from developed economies have performed almost as well: UK 7-10 years: +8.6%, US Treasury 7-10 years: +7.7%, Australia 7-10 years: +7.7%, France 7-10 years: +6.4%, Germany 7-10 years: +6.1% (in spite of the fact that all these German bonds currently have negative yields) and Japan 7-10 years: +4.0% (also all trading with negative yields). Other types of bonds also have done well through the first half of the year: US corporate bonds are +7.7% and US municipals are +4.3%.

Other Markets

Currencies were obviously big movers during the quarter. The yen was the big gainer during the second quarter, gaining another 9% versus the US dollar, and reaching 100 to the dollar at one point. Obviously, the British pound was down post-Brexit, ending the quarter down approximately 9% against the US dollar (since it had rallied before the UK referendum). The euro was weaker during the quarter post-Brexit, ending down 3% versus the dollar.

Year to date, currency returns are more varied. Beaten-down currencies from oil/commodity producers lead the gainers for the first half: Brazilian real +23.2%, Russian ruble +12.0%, Canadian dollar +7.1% and Norwegian Krone +5.7%. First half losers include the Argentinian peso -14.0% (as Argentina heals from Kirchner's disastrous presidency), the British pound -9.7% and the Mexican peso -5.9%. Asia shows a distinct dichotomy: Japan's yen rose 16.6% so far this year as investors continue to unwind the yen carry trade while the Chinese yuan (-2.2%) and the Indian rupee (-1.9%) weaken on net capital outflows. The euro (and to a lesser extent the US dollar) has benefitted from capital flows from countries hurt by the commodity swoon of the first quarter and political uncertainty throughout the year, rising 2.3% so far in 2016.

Going Forward

Economy

As expressed above, the early June jobs report showing the anemic growth in jobs and the revision down of the prior two months' job reports established a pattern which more vividly shows a slowing

of US jobs gains and thus, economic growth, since jobs had been the last real bastion of continued strength in the economy. The July jobs report softened these sentiments with a larger than expected gain, although the June jobs number was revised even lower. The various monthly Fed regional reports have continued to show deceleration, adding to pundits' concerns about the possibility of recession in 2016/2017. However, early July reports have shown a little more strength, quieting recession concerns for 2016.

Continued anemic US economic growth combined with the Fed's extremely low interest rate environment has continued to keep the US out of recession, although inflation continues to ratchet up, meaning even if we are not technically in a recession, many people are feeling recessionary forces as rents, insurance, tuition and food continue to rise in price while wages remain stubbornly stagnant.

In the face of this slow economy, the Fed has indicated its shift back to a neutral stance, meaning its tightening bias is all but over, and this has once again buoyed financial markets, limiting losses in stocks and propelling bond yields to lows never before seen in history. The stock market appears to be signaling a bounce in economic activity in the second half of 2016. Catalysts for this bounce, however, are hard to predict.

Equities

Post-Brexit, the lack of any real news, coupled with dovish rhetoric from most central banks, allowed world equity markets to recover their losses over the week or two following the vote. Interestingly, the early July slight improvement in macroeconomic results continued to buoy markets, and US markets took off on a consistent nine-day run of new highs, although volume was quite low (showing lack of participant enthusiasm) and new highs were very low (a few large stocks hitting highs but most stocks not doing so, showing a lack of breadth and enthusiasm).

One reason for this lukewarm rise to new highs is because second quarter earnings kick off during the second week of July. For the fifth quarter in a row, earnings are falling versus the previous quarter, showing a continuing deceleration in earnings, despite many stocks beating analysts lowered earnings estimates. In addition, FactSet's [a key financial industry source for earnings estimates] mid-July report shows earnings estimates for the third quarter have just dropped to an aggregate loss, indicating a sixth quarter of falling earnings. This is the first time earnings have dropped for this long since the 2008-9 Financial Crisis, and extended "earnings recessions" like this generally precede recessions. Regardless, continued lower earnings point toward lower stock prices unless earnings are expected to rebound soon or the attraction of future earnings leads to P/E multiple expansion.

The market is still expecting a rebound in earnings toward the end of 2016, and this seems to be the reason, combined with easy central bank policy worldwide, that the market has risen in July. We are less sure of this occurring, because according to FactSet's earnings forecast for Q3, 6 of the 10 S&P sectors are supposed to show declines, led lower by drops in energy company earnings, although Consumer Staples, Industrials, Financials, Technology and Materials sectors are also expected to show worse earnings. We believe falling earnings, conservative earnings guidance and uncertainty

around geopolitical and financial stress will keep a lid on stock price gains for the rest of 2016 as late-year earnings growth is gradually priced out of the market. Having said that, we are maintaining positions in more stable, less volatile US stocks because recessionary forces don't seem to be building yet, allowing these companies to maintain market share and keep their dividends coming.

Lack of concern over risk, as signaled by the stock volatility index (VIX) under 12, shows that stock market participants feel like the Fed is accommodative and "out of the game," the economy is still growing (albeit sluggishly) and geopolitical events are mostly known and priced in. We disagree with the apparent certainty that this very low volatility reading forecasts.

Precious Metals

Mid-July has seen a slight correction in precious metals prices as investors see lower risks in financial markets than previously thought pre-Brexit. As stock markets have rallied worldwide, safety "plays" like precious metals investments have taken a breather. We expect this pause to be temporary because US and European economic issues continue, China and Japan are having trouble resolving slowing economies and too much debt, and emerging economies are not providing enough growth to sustain much worldwide growth overall.

Precious metals have continued to benefit from: almost universal dovishness by world central banks (since the Fed signaled a more dovish stance in February), uncertainty around geopolitical upsets (especially the Brexit vote), the growing realization that inflation is starting to impact economies (including the US economy), and the continuing fall in world interest rates – with negative interest rates incentivizing people to hold gold instead of bonds. We see these factors continuing and believe that many will intensify, pushing more investors to protect themselves by owning precious metals.

We also think recent higher gold and silver prices, coupled with the abovementioned factors and stable or falling energy costs, will drive higher profits for precious metals mining companies. Rising profits will lead to higher stock prices in the future, especially as higher gold prices make more of the companies' gold discoveries more economic to mine and add to bookable reserves (that had to be written off in the past when prices dropped).

Energy

Energy, especially crude oil, rallied through the second quarter as supply upsets kept the supply/demand balance closer to even in the short-run. However, as July has progressed, the large inventory levels in crude oil, as well as in gasoline, have become more of a concern to the market: crude oil because the largest storage surplus since pre-World War II hasn't dissipated as fast as expected, and gasoline because inventories are building rapidly worldwide, even during peak usage months. Thus, after peaking in early June near $52/bbl, WTI has been sliding, breaking the multi-month uptrend started in early February, and threatening to break support around $44/bbl. In addition, the contango in prices has been increasing, which is an indicator of slowing demand for prompt

deliveries. Finally, as calculated by The Gartman Letter on 7/25/2016, since the last week of April, crude oil prices have fallen 4.6% while gasoline prices have plunged 14.8%; they point out that product prices and demand drive crude oil values, and with gasoline prices dropping, crude prices will be under more pressure.

We continue to believe that high inventory levels, coupled with weak worldwide economic growth (i.e. lower demand growth) and cash-strapped producing companies and countries, will combine to keep crude oil production too high to maintain prices in the $40s/bbl. We anticipate a fall into the $30s/bbl (and possibly high $20s) in order for supply and demand to better balance and work off some of the excess inventory.

Natural gas in the US also peaked in early June, led higher by high temperatures over much of the consuming area in the Eastern US. However, moderating temperatures, high volumes of supply, lack of any early-season hurricanes and higher injections into storage (showing less demand than expected) have cut prices to the $2.70s in mid-July, setting up for a fall in prices unless hurricanes start to enter the Gulf of Mexico/Southern US area.

Bonds

The growing realization that expected real rates of return are dropping has led large institutional investors worldwide to start buying more bonds, especially US bonds. This buying, combined with continued quantitative easing from the ECB (which now includes buying of euro corporate bonds) has led to a further drop in bond yields during the first part of the third quarter, and we expect these trends to continue. In addition, the maintaining of negative short-term rates by Scandinavian, Swiss, European and Japanese central banks has led to negative rates on longer-term bonds as investors search for safe yield and traders front-run central bank purchases of medium- and long-term bonds. Thus, Bank of America (BofAML) now estimates more than $11.7 trillion or 33% of the BofAML Developed Market sovereign index of bonds trade with a negative interest rates. US Treasury bonds make up nearly 50% of the remaining developed-world sovereign bonds with a positive yield available to investors, making them more attractive for worldwide bond buyers. Finally, BofAML believes Japanese and European investors (especially pension funds and insurance companies) are being pushed out of their bond markets by QE and are going to the US Treasury market for duration and positive yields, with the catalysts for ending QE still many quarters away. We agree with BofAML's analysis and see the impetus for more buying of Treasuries to continue. More recent news releases confirm this sentiment: both Germany and Canada's Canadian Imperial Bank of Commerce have sold bonds to the investment community with negative yield (Germany sold 10-year bonds, CIBC sold 6-years), meaning that investors who bought these bonds are guaranteed to lose money if they hold the bonds to maturity. These bonds highlight the relative attractiveness of positively-yielding similar duration US Treasury bonds.

We also believe the buying pushing down "safer" yields on sovereign bonds has pushed people further out on the risk curve in order to maintain income levels. When trouble starts to hit (and signs are appearing), we see another rush into positively-yielding US Treasuries for safety as more speculative

yield securities could show losses. Trouble has already appeared post-Brexit with the "gating" (prohibition of withdrawal of funds) from at least six property funds that invested in London commercial real estate. The Brexit vote has worried some investors that the European financial sector will withdraw from London, and many have tried to withdraw funds from income generating funds which were set up to invest in the booming London real estate market. Now, values of real estate are heading downward, and investors have tried to withdraw their money. This hurts all remaining investors in an illiquid fund that holds commercial real estate positions. So these funds have restricted withdrawals to protect liquidity and to give them time to try to raise capital, with a real estate market facing uncertainty from falling valuations and the possibility of a shrinking financial sector post-Brexit.

We see this trouble in British real estate funds as analogous to the forewarning of trouble announced in the summer of 2007 by the Bear Stearns funds which were invested in speculative mortgage-backed securities. The trouble in the Bear Stearns funds ended up being the true "canary in the coal mine" which pre-saged wholesale problems in mortgage backed securities that many investors owned for the juicy yields with the thought that US housing "never goes down in value." Now, lots of investors own London real estate because of the high yields offered by the funds and the thought that London real estate was underpinned by the large (and thought to be still growing) financial sector. Now, those perceptions have changed and we are seeing problems in yield vehicles backed by more speculative cash flows (highly-levered, bought-at-the-top London commercial real estate). We hope this doesn't predict trouble like the Bear Stearns funds did in 2007/2008, but European financials are down strongly in 2016, showing a lot of stress in the financial world that is not being expressed in US stock prices.

Other Markets

Brexit caused a lot of volatility in many markets, but European currencies are probably the nexus of the damage, especially the British pound. When the results were being announced, the pound dropped almost 15% in an evening, and has not recovered much. We have not participated in trades around the pound, but the combination of uncertainty around the UK economy plus the Bank of England's pledge to provide liquidity to avoid extra problems in the economy was understandably bearish short-term. However, the UK economy was relatively strong pre-Brexit, so longer-term, the pound could rebound.

Much more germane to our portfolio, the euro also weakened as many saw Brexit as a source of uncertainty and as a precursor for other exit votes by dissatisfied EU members. We agree with the analysis that weak EU economies could be hurt by Brexit's uncertainty, meaning the ECB could be under more pressure to provide monetary easing, leading to a lower euro. Thus, we will maintain our euro short positions, and we may add to them if we see a catalyst underappreciated by markets.

In later news, our old friend, the yen, came alive after Prime Minister Abe's party, the LDP, resoundingly won Upper House elections on July 10th, giving the LDP the Prime Ministership and (with its partner party Komeito) supermajorities in both the Upper and Lower Houses of the Diet (their parliament). This large mandate gives Abe and his advisors virtual carte blanche to implement

new strategies to stimulate the Japanese economy, most of which will weaken the yen. Thus, we have returned to a short yen position, adding a half position after the vote, and we will look to add to the position as policies are formulated and implemented.

Notable Comments on "Brexit"

Before we get to this quarter's Commentary, we thought that we would comment on and share some of what we think are very interesting and thoughtful comments around the British vote to leave the EU.

First, our impressions. We really have three main points that we think are important: 1) We think Great Britain is in a unique position: a major member of the EU but separate in so many ways: having their own currency and independent central bank, being geographically separated from the Continent, etc. that this referendum, when viewed later, will not radically change England economically but should free it from so many rules so it can recover economically faster than EU countries; 2) While economically Brexit will be a mild long-term benefit, it is causing a huge stir in Europe because of the EU leadership's fear that Brexit will cause others to also want to exit. This we see as inevitable and not "caused" by the British – they were just in the best position to execute it first; and 3) This is actually historically momentous because it marks another milestone in British/European history that changes the track of democracy (for the better). Rarely can we identify true mileposts in history except in retrospect. However, this appears to be an action by a large majority of the population to express that regulation and the growth of government and the "nanny state" has reached its limit, and the British want to govern their country according to their customs, thoughts and history instead of further ceding authority to an increasingly overreaching and intractable EU bureaucracy half governed by a huge and growing bureaucracy in Brussels, Belgium and half by a cadre of high officials in Germany, France and extra-national agencies like the International Monetary Fund.

As you probably know, the surprise outcome was not anticipated by financial markets. The day after the vote (Friday, June 24) was one of the more volatile days in financial markets in many years, with the pound falling ~15% and some European banks (especially British) falling up to 50% by the end of trading Monday, June 27. However, markets recovered quite a bit of the down moves by month's end, showing the confusion as to whether Brexit was the disaster it was forecast to be or was more complicated and much less dire situation.

But don't take our word alone on this, listen to these interesting viewpoints on Brexit:

Dennis Gartman, market commentator and writer of The Gartman Letter in his letter of 6/27/2016:

"…to the people of the United Kingdom: Well done: very, very well done. You have voted for freedom above all else. You've sent a message to the central government in Brussels…you have sent a message to the rest of the world that central planning fails…You have proven to the world that local government governs best and that government removed from the people governs tyrannically and badly."

George Friedman, former founder of Stratfor and currently heading Geopolitical Futures, wrote in "The Surprise at Brexit and the Social Crisis Behind It" (6/25/2016):

"…The challenge that was posed in the U.K. referendum is present in many countries around the world, albeit in different forms. What has become universal is the dismissive attitude of the elite to their challengers. It is difficult for the elite to take seriously that the less educated, the less sophisticated and the less successful would take control of the situation…The distance between what I will call the technocratic elite and the increasingly displaced lower-middle and even middle class is becoming one of the major characteristics of our time. This elite did not expect "leave" to win because it was clear to them that the EU would work itself out. They didn't know anyone who disagreed with them – a measure of how far out of touch they had become with the real world.

Ben Hunt, Chief Risk Officer for Salient Partners and writer of the Epsilon Theory newsletter (6/24/2016):

"Brexit is a Bear Stearns moment, not a Lehman moment. That's not to diminish what's happening (markets felt like death in March 2008 [when Bear failed]), but this isn't the event to make you run for the hills. Why not? Because it doesn't directly crater the global currency system. It's not too big of a shock for the central banks to control…[Central banks will intervene, which] works for a while, just like it worked in the aftermath of Bear Stearns. By May 2008, credit and equity markets had retraced almost the entire Bear-driven decline. I remember vividly how the Narrative of the day was 'systematic risk is off the table.' Yeah, well…we saw how that turned out...**<u>Bottom line</u>, if you ever needed a wake-up call that every crystal ball is broken and we are in a political storm of global proportions, today is it" [Emphasis mine – KS]** ***[Further explanation: Bear Stearns and Lehman Brothers were both investment banks that failed in 2008; when Bear failed in March, markets were roiled, but when Lehman failed, the financial crisis transformed into real turmoil]***.

George Friedman, again from Geopolitical Futures, wrote in "Is Brexit the End of the EU? (6/26/2016):

"The UK is Germany's third-largest export market. It is the fifth-largest for France and Italy. It is absurd to think these countries would stop selling to Britain or put tariffs on British exports. The British would respond in kind, and Europe cannot afford a trade war even if it feels insulted…British banks channel global capital and are a huge source of investment for the Continent. The EU is hardly going to hamper that flow by blocking investments…Given Europe's weakness, the burden is on the EU to show continuity. It needs the flow of capital. Further, it is the clients who will determine the world's banking hubs. London has been a traditional banking center preferred by foreign clients. New York – not Frankfurt – is the alternative to London. If clients had wanted to bank in Frankfurt, they would already have done so…The economic impact of the UK leaving the EU is minimal because the EU – not Britain – is the weak player."

Brian Wesbury, chief economist at First Trust Advisors, in a note to Dennis Gartman published in The Gartman Letter (6/28/2016):

"If you listen to [EU] policymakers [and financial market supporters of "Remain", for the most part] around the globe, they all seem to agree on one thing: the need to avoid: "uncertainty." In their thinking, the battle against uncertainty is a never-ending struggle, and if only the world were more certain, the economy would be doing much better. Which is kind of odd when you think about it, because if you really want certainty, you could get much more of it than in the old Soviet Union or present-day North Korea. Those economies minimize flexibility, choice, and freedom, while maximizing certainty. It's the certainty of the prison cell, but it's certainty nonetheless."

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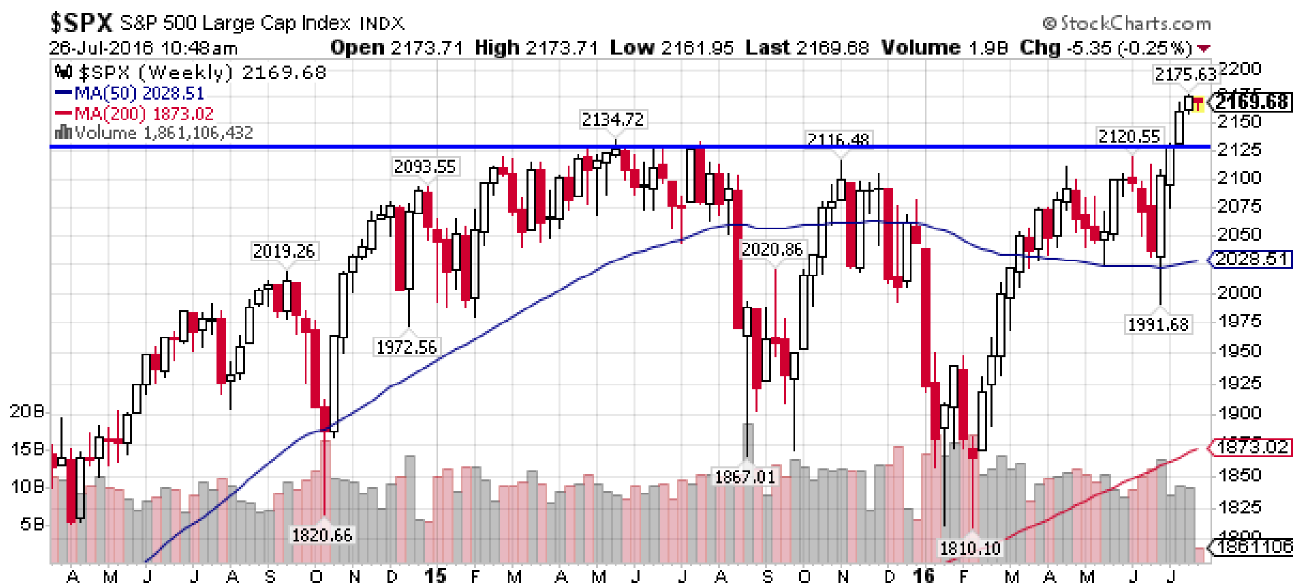
Kanos Quarterly Commentary

Indicators: What Are the Markets Telling Us? And What Are They NOT Telling Us?

The aggregated opinions of those trading in financial markets can sometimes be discerned by the "setup" in one market, as displayed by a chart and/or exhibited by statistical analysis. Thus, we will present some charts and graphs that we believe give us some insight into how the market may move in the future. Some predict higher prices, some lower, and some much lower, so we are dubbing the three sections: The Good, the Bad and the Ugly.

The Good

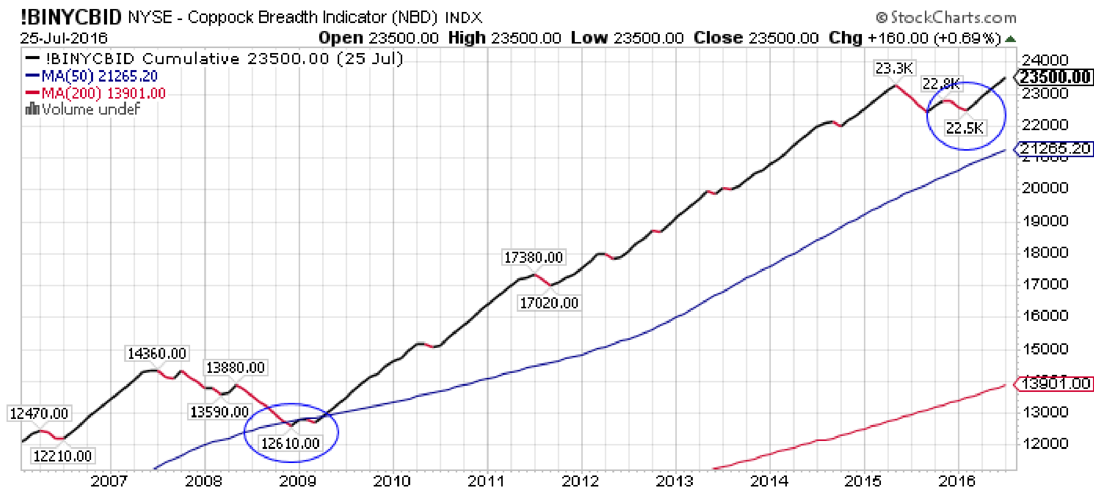
1) **All Time Highs** – World stock markets, having re-assessed risk after the UK referendum, have for the most part rallied, led by the US stock markets where the S&P 500 has established new all-time highs during July. This price action is considered bullish, after establishing a new high in mid-2015 (marked by the blue line), testing that high during late fall 2015 and earlier in the summer of 2016. The chart below shows the breakout to new highs:



2) **A Positive Advance Decline Line / Market Breadth** – Stock markets are usually considered most "healthy" when many different sectors are rallying at the same time. This is called market breadth, and when market breadth is high and markets are rising, this is considered a bullish signal. One way to measure the breadth of a market is by taking the amount of stocks that rose in a day and subtract the

amount of stocks that fell; if more stocks rise than fall, the number is positive, and if more stocks fall, the number is negative. If one adds days together, you should be able to discern a positive or negative trend, i.e. if there is positive breadth, the count will produce positive numbers which when added together will rise over time. If breadth is negative (more stocks dropping than rising), the graph will fall over time. This type of graph is called the Advance-Decline Line ("the AD line"), and the AD line of the New York Stock Exchange clearly shows more stocks rising than falling over 2016, indicating strong market breadth and reiterating a bullish environment for US stocks.

3) **Uptick in the Coppock Guide** – The Coppock Guide (or Coppock Curve) is a very long-term momentum indicator developed by Edwin Coppock and first published in 1962. It gauges when the market is oversold in the long-term, and reverses when investors move to being more interested in future moves than past losses (marked by blue circles below). According to Doug Ramsey of the Leuthold Group in a 6/14/2016 Investment New article, "[w]e've had [only] 26 signals in 90 years, and the last one was in May 2009."



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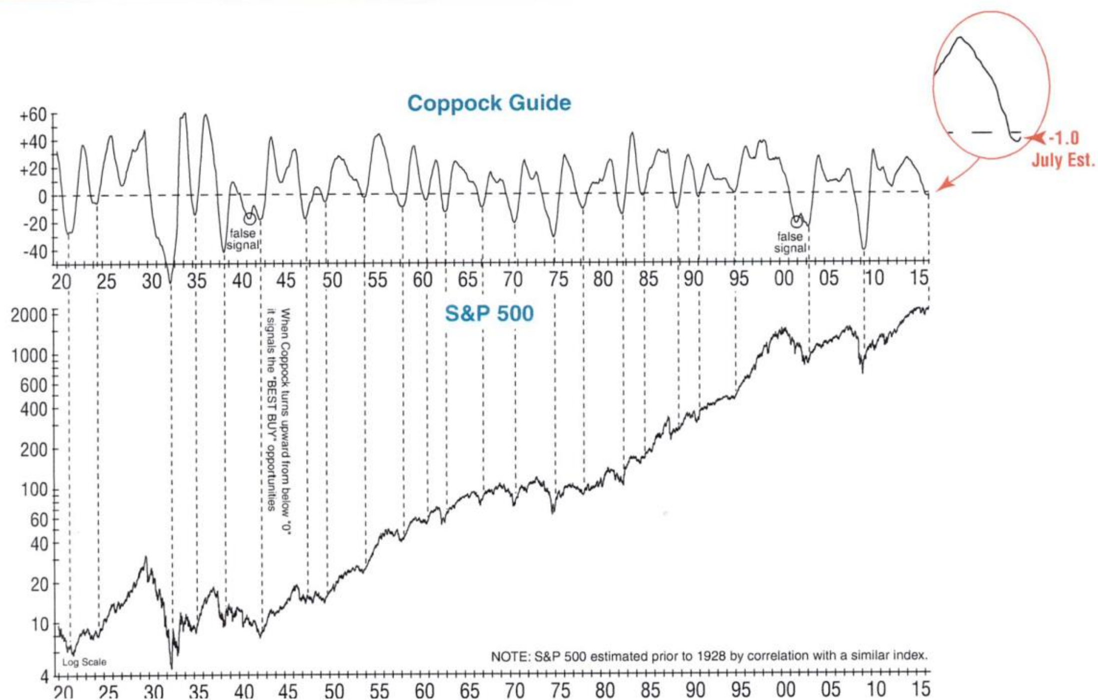
The following is a better explanation about the Coppock Guide signal from Investech Research's 7/15/2016 Interim Bulletin. According to James Stack of Investech Research, the Coppock Guide went negative in February and has started to turn up, signaling a new bullish phase of the market. This is a powerful, infrequent signal that has only shown two false readings in the past 90 years.

Coppock Guide Signal

The Coppock Guide has been described as "a barometer of the market's emotional state." As long-term momentum in the market changes direction, this indicator reverses course and moves slowly from one extreme to the other. Once the Coppock Guide drops to '0' or below, an upturn can usually be treated as an excellent buying opportunity. Even when the Coppock Guide only marginally resets itself, historical evidence still shows that a positive move up from below '0' signals a better time to buy.

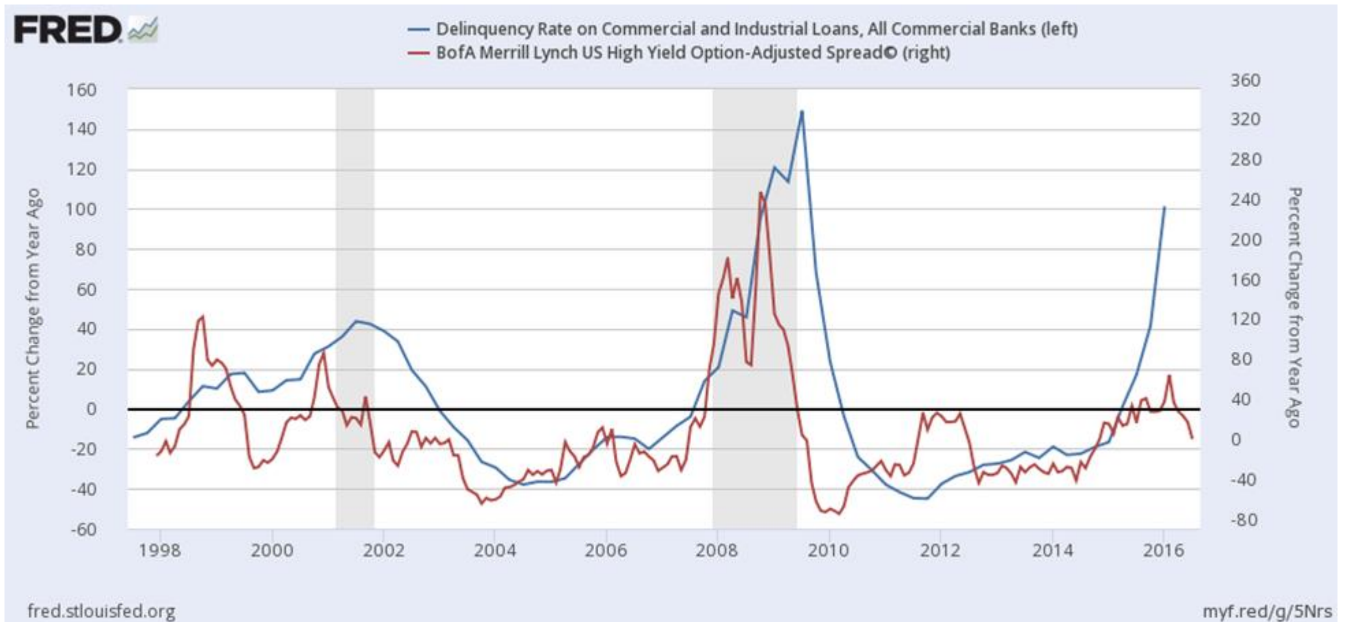
In February, the Coppock edged into negative territory. The market's strong runup from the February lows caused an uptick in this gauge at the end of June. As shown in the red ellipse below, this upward trajectory is projected to continue in July. Though there have been two false signals in the past, historically, even a small upturn in the Coppock Guide has reliably predicted that further market gains lie ahead.



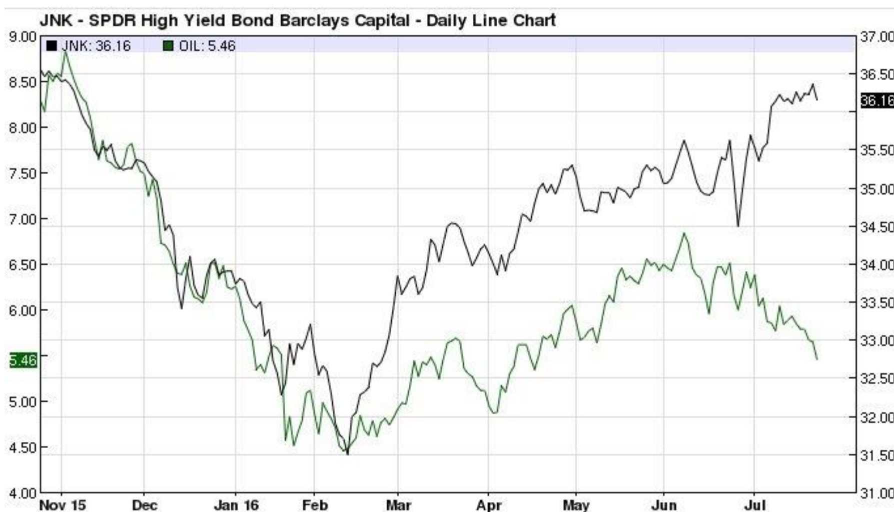
The Bad

1) **Credit Woes Building** – Credit problems are building, and there seems to be almost no concern in the financial markets. This graph from CMG Wealth in their "On My Radar: Junkyard Dogs" article from 7/22/2016, shows the delinquency rate of Commercial and Industrial loans made by commercial banks (as measured by the St. Louis Fed) has been rising sharply, no doubt led by soured energy

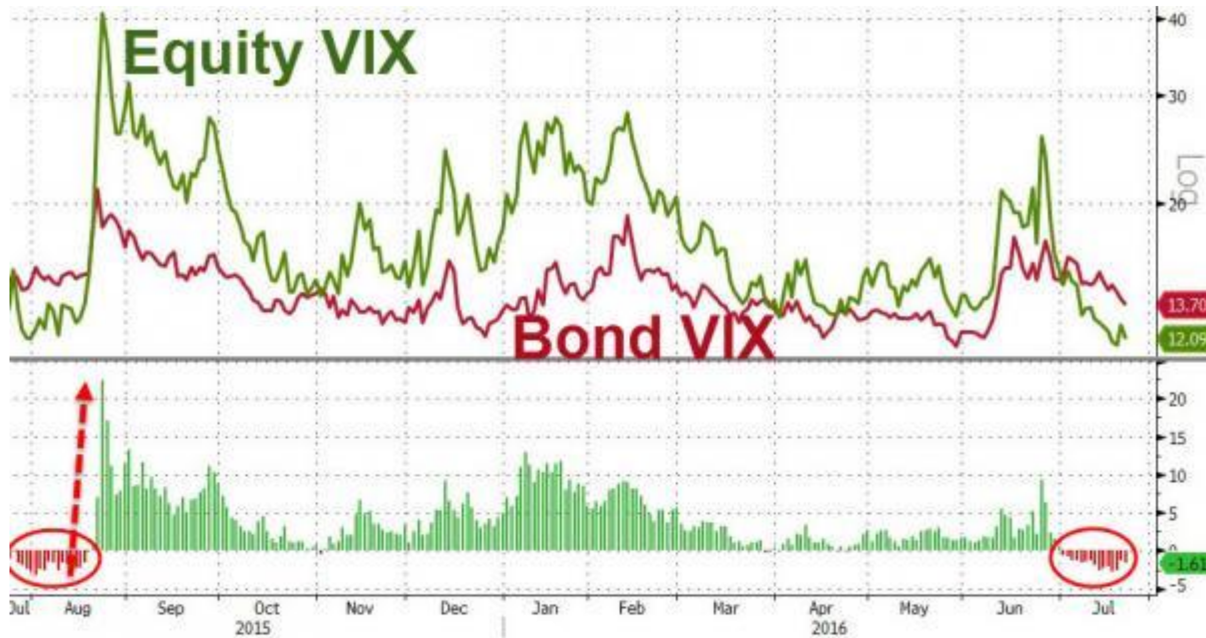
loans, but not falling back as energy prices have rallied in mid-2016. Superimposed on the graph is the spread of high-yield debt over equivalent timeframe Treasuries; this spread shows the amount of risk taken when buying high-yield debt. As the graph shows, the spread is dropping, even while C&I delinquencies rise – a dangerous combination most probably indicating investors ignoring credit signals as they "reach for yield" in high-yield debt due to lack of less risky alternatives. To the left in the graph, C&I delinquencies were rising in 2007 when HY spreads were still low and falling – but high yield bonds lost on average almost half their value in 2008/2009 and "the yield on high yield bonds rose from 6% to over 20%," according to CMG Wealth. We see investors reaching for yield and ignoring credit signals flashing red as a harbinger of problems to come in financial markets.



The following graph shows high-yield bonds (dark line) directly compared to the oil price (green line), from TheDailyShot.com 7/26/2016.



2) **The volatility index of bonds is higher than the VIX for equities** – Equity volatility, as measured by the VIX Index, is so low right now that it is lower than the volatility expected in bonds. The last time this happened was last August, when markets went into a freefall as Chinese devaluation combined with US fears of Fed tightening. With a stronger dollar, all-time high US equity prices, and a decelerating Chinese economy, all the same elements are in place for a big US correction. This graph from a 7/22/2016 ZeroHedge article shows the situation graphically.



3) **Weak World Equity Indices (Especially as Compared to US Stocks at Record Highs)** – Equity indices in the rest of the world are not preforming nearly as well as US markets [shown at the beginning of this commentary], although they have shown resilience post-Brexit. They still look like they are in "poor health" as they seem to be trending down.

Japan (Nikkei):

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Europe (Euro Stoxx 600):

China (Shanghai Composite):

4) **Weakness in Some Important US Industry Sectors (With US Indices at Record Highs)** – As we've shown previously, the US markets are at or near all-time highs, but some important sectors not only haven't set new highs, they are showing either resistance to gains or outright weakness. When important sectors don't follow the main trend, the trend might be in trouble. Also, Dow Theory, which says trends are in place when the Dow Jones Industrial Average and the Dow Transportation Average move in tandem, is out of sync, due to the Transports' underperformance/non-confirmation. These divergences are a serious concern.

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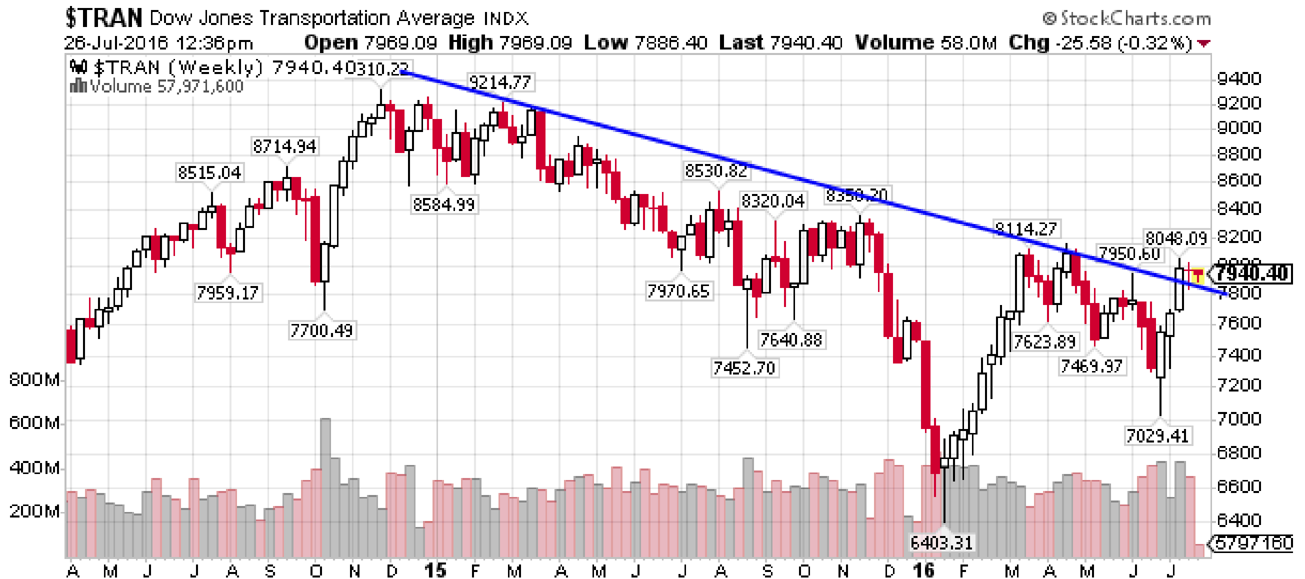
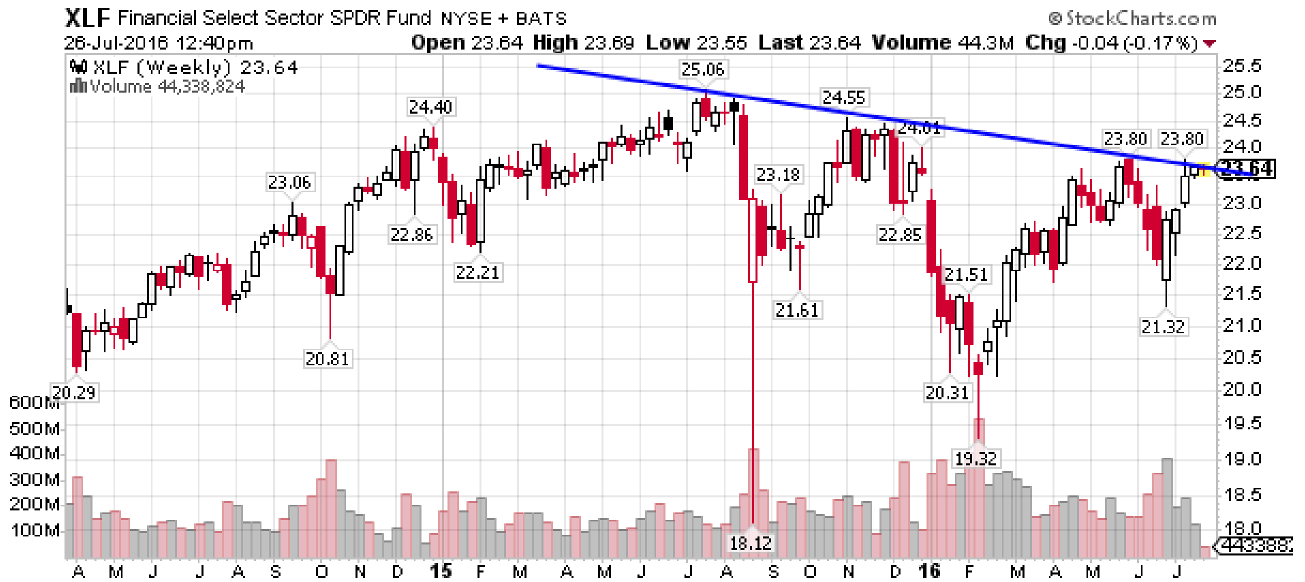
Dow Jones Transportation Average:



Financials (generally considered one of the most important US equity sectors):



Biotech (as represented by the Nasdaq Biotechnology ETF) – Biotechs were one of the leaders in the equity bull market from 2009-2015 in which the IBB ETF rose more than 400%; now it is lagging badly, especially as the S&P 500 moves to new all-time highs. This "bad action" and divergence by one of the former leaders of the bull market is concerning:

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The Ugly

1) **The Lowest Interest Rates in History** – US Treasury rates have never been lower than they were in July, and European interest rates have been identified by Deutsche Bank as being the lowest in at least 500 years. With negative interest rates (never before seen for extended periods) extant in both Europe and Japan, interest rates are signaling a catastrophe (at some point) which drives investors to buy bonds regardless of the high cost/poor future prospects. Most pundits point to central banks buying so much of this debt, but investors also continue to buy debt at these very low levels as a hedge against economic disaster. It is very concerning to have rates so extremely low and potentially falling more in the near future, especially with US stocks at all-time highs and economic growth slow.

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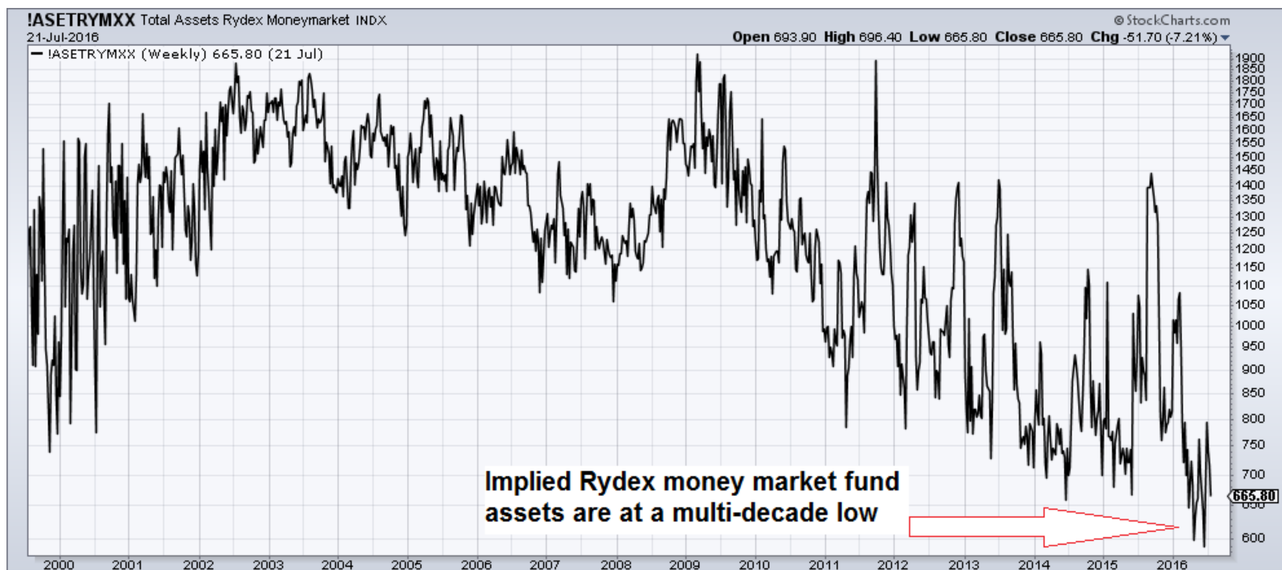
2) **Arguably the Lowest 'Cash on the Sidelines' in Decades** – the Rydex family of mutual funds has a large number of sector funds that allow market participants to gauge market sentiment by seeing how Rydex mutual fund holders, who are usually more sophisticated investors due to the wide offering of funds and low costs, are allocating their assets. In the following graph from Peter Tenebrarum's "A Fully Automated Stock Market Blow-Off" on Acting-Man.com, the Rydex money market fund assets [representing cash on the sidelines] are at lows not seen in the 2000s (which makes sense if cash earns no interest), showing a level of complacency toward risk not seen in many years.



3) **Valuations Are Rising Again, Back Toward The Highest in More Than A Decade (Even Higher than During Financial Crisis)** – the geometric average of four typical valuation indicators (average P/E ratio, ten-year average P/E ratio, comparison to replacement costs and price levels compared to average) are climbing back toward the third highest in more than a century – even higher than valuations seen before the 2008/2009 Financial Crisis. While these valuations are very much influenced by very low interest rates, low interest rates can only stimulate the economy so much, as our slow growth US economy is currently showing. This is alarming because such high valuations are happening while US economic growth is very slow. We have used this graph before, which is from Advisor Perspectives.com/dshort website and its 7/6/2016 article "Market Remains Overvalued, Up Slightly from Last Month."

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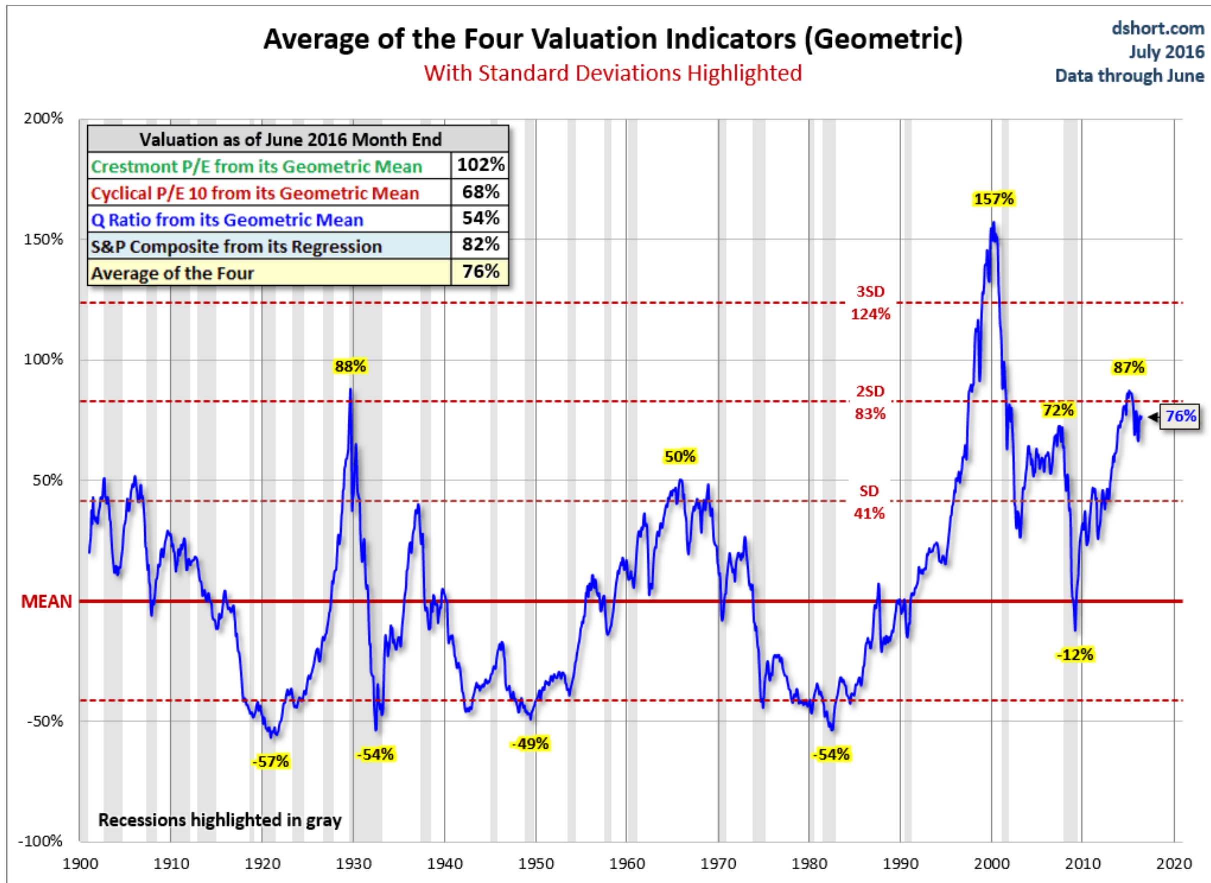

Conclusion: As we have stated above and shown from this year's outperformance, we believe all the factors shown above point toward a continuing but aging bull market increasingly reliant on central bank monetary stimulus for support/advancing. However, the efficacy of easy monetary policy to stimulate economic growth seems to be nearer its end, Moreover, its continuation seems to increasingly influence prices of goods and services, which is starting to stoke inflation. In spite of this fact, we see central banks increasing the amount of monetary stimulus as economies slow further, which we see helping our investments that benefit from inflation, our US large cap equity positions (in less volatile sectors) and our short euro and yen positions. More stimulus will also lead to more volatility, which we see benefitting our Treasury and gold holdings as investors move more assets toward safer holdings. Thus, we continue to maintain equity presence with large holdings in precious metals, US Treasury bonds and short G7 currencies. We don't see Brexit, its fallout on Europe or the US presidential elections changing our positioning during the summer/fall period unless we see more clarity around US elections.

The Managers of Kanos Capital Management
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