KANOS
CAPITAL MANAGEMENT, LLC

Fourth Quarter 2016 Investor Letter

Portfolio Comments

We at Kanos are poised to take advantage of the "sea change" that has occurred with the election of a Republican President and a Republican majority in both houses of Congress. We are hopeful that government excess and overreach which has impeded growth and generated little hope in the business community (outside of government spending beneficiaries) is in the rear view mirror.

The quarter was dominated by big market shifts, powered halfway through the quarter by the election of Donald Trump and Republican majorities in both houses of Congress. The mid-November to early December euphoria cut into our gains from earlier in the year. The surprise election result's big beneficiary was the US dollar, which strengthened significantly, helping our short euro and yen positions significantly. The surge in US stock markets especially helped our industrial, defense and energy positions. Our consumer stocks, telecom and utility positions all finished the quarter on "up notes" after starting the quarter weaker. Dragging down our performance for the quarter were our bond positions, our precious metals positions, our consumer staples stocks and anything that was considered "safe". These safety trades improved during the last half of December, cutting losses in our portfolios as the reality of a slower pace of change under Donald Trump readjusted markets somewhat. We believed we were well-positioned for a possible Trump victory, but underperforming "hot money," post-election, drove Trump "trend stocks" far past reasonable valuations, even with large uncertainties concerning Trump. We did adjust portfolios, however; our responses were measured and were made with future trends in mind: we sold all of our Treasury positions, we cut back on our poorer-performing precious metals positions and added some attractive small cyclical stocks and some market beta. More detail about purchases, sales and our outlook for the future can be found in the next few pages.

Fourth Quarter Market Conditions

The fourth quarter showed the wildest swings of the year in many markets. The market was volatile during October in front of the US elections, but the election of Donald Trump as the US President-elect, with a Republican majority in both houses of Congress, led to a "sea change" in the outlook for several markets, most notably the US stock market.

October was a down month in many markets as the uncertainty surrounding US elections, coupled with mounting political and economic uncertainties worldwide, unsettled markets. US equity markets posted their worst month since January, and the S&P 500 was -1.82% for the month, led down by Healthcare (spooked by Clinton remarks and lackluster profit reports), Telecommunications (rising rates and AT&T mega-deal for content provider Time Warner) and Real Estate sectors. Financials

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and Utilities were the only sectors which showed gains during the month. The other two big stories for the month, the US dollar and Treasury bonds, were the catalysts for most market moves – the dollar was up and bonds were down. Rising yields (and falling bond prices) this month led to lower prices in many interest rate-sensitive investments, and were caused by rising confidence in the US Federal Reserve hiking rates in December (and in 2017) as well as the emergence of inflation fears. The strong dollar was caused by increasing confidence that the US economy is growing more than most developed world countries. Precious metals were hit early in the month due to the expectations of an imminent Fed rate hike and the hope for re-emerging US economic growth; the metals recovered the rest of the month and into November as those concerns faded and were overshadowed by growing inflation concerns. Crude oil, after reaching the mid-$50s/bbl in early October on the potential for supply limitations, dropped much of the rest of the month, ending at a multi-month low after the hoped-for supply agreement took longer to materialize and worldwide supplies showed growth in the meantime.

November was a momentous month, both economically and politically. In the second yuuuuge political surprise of the year (following Brexit), Donald Trump beat Hillary Clinton for the US Presidency, and Republican majorities were achieved in both the Senate and House of Representatives. This change caused economic waves throughout the world, as analysts, traders and pundits refigured world political, economic and monetary dynamics. After initial plunges, US and many developed world stock markets rallied for most of the rest of November as a Trump presidency/Republican majority was deemed hopeful for growth and better business conditions. The S&P 500 advanced 3.7% (dividends included) during November, led by strong performances in the formerly moribund Financial (+13.94%), Industrial (+8.85%) and Energy (+8.40%) sectors. "Safer", higher-yielding sectors, including Utilities (-5.40%), Consumer Staples (-4.29%) and Real Estate (-3.07%) were losers for the month. Rising hope for reigniting growth in the US industrial sector led to big gains for oil, highlighted by a 9.3% daily gain on the last day of the month [due to an OPEC production cut] with WTI closing at $49.44/bbl, up 5.5% for the month. The transportation stocks were also big winners in November, with the Dow Jones Transportation Average rising 11% for the month, its largest gain since 2011. Small-cap stocks had their best month since 2010. These gains occurred despite a US dollar which was up strongly post-election. The big losers for the month were the "safer" assets, including bonds and gold. Long-term bond yields rose more than +0.5% in November, with the 10-year Treasury Bond ending at 2.365%; this was the largest one-month jump in yield since December 2009. Gold also had a poor month, falling 7.9% as optimism over a united US government "trumped" continued economic uncertainties around the world. Interestingly, the Nasdaq rose only 2.6% for the month, and the "FANG" stocks (Facebook, Amazon, Netflix and Google [Alphabet]) were weaker after the election as expensive growth stocks were swapped for cheaper industrial stocks deemed to have greater upside. Internationally, developing world stock markets were strongest, with Russia's Micex (+4%) and China's Shanghai (+3%) leading the way, while losers included Brazil's Bovespa (-5%) and weaker European economies: Spain (-4%) and Portugal (-3.5%).

In December, financial markets initially built on November gains but flattened out late in the month, weakening into the new year. The S&P 500 rose +1.98% (including dividends), with the Telecom, Utilities, Real Estate and Financial sectors gaining the most, while the Consumer Discretionary and Materials sectors rose marginally. The markets were driven by continuing optimism about expected

corporate and individual tax cuts, regulatory streamlining and fiscal stimulus, although that was tempered by lack of improvement in late December economic reports and, of course, the Fed raising short-term interest rates in mid-December. Overseas stock markets also rose for the month, although many developed world markets also failed to make new highs after early December rises. Treasury bonds swooned mid-month but recovered their losses late in the month as investors rotated from stocks to beaten-up bonds; the 10-year Treasury ended at 2.446%, virtually unchanged on the month. The US dollar was up for the month, pushing down both the euro and the yen. Gold also suffered with a stronger dollar falling initially but bouncing back in mid-December to limit its monthly loss to 1%.

Equities

Equities were the stars of 2016 after a horrible start to the year. The resolution of political situations (US elections, Brexit, Italian constitution), coupled with the continued monetary stimulus from the European, Japanese and Chinese central banks, led to a fertile environment for equity gains all over the world.

In the US, the S&P 500 was up +3.82% (including dividends) during the third quarter, led by huge performances by the Financials (+21.1% during the quarter), Energy (+7.28%) and Industrials (+7.21%) [all returns include dividends], all considered prime beneficiaries of President-elect Trump's expected policies. Underperforming sectors for the quarter included Healthcare (-4.00%, thought to be the target of price controls) and Real Estate (-4.41%, reflecting the rise in long-term interest rates that occurred during the October-November election period).

These outsized fourth quarter returns helped propel US equities to strong yearly performances: the Dow Jones Industrial Average led major indices higher, gaining +13.4% for the year. The S&P 500 gained +11.96% in 2016 (including dividends) and was led by the following sectors: Financials (+22.80%), Energy (+27.36%), Telecoms (+23.49%) and Industrials (+18.86%). Laggards included many of the stars of the first half of the year: Health Care (-2.69%, including dividends), Real Estate (+3.39%) and Consumer Staples (+5.38%), the final two are considered yield vehicles that underperformed when long-term interest rates climbed higher during autumn.

Internationally, the strong dollar led to falling currencies around the world, which in many cases led to rising stock markets. Russia's RTS index soared +52% during the year as Russia was considered the direct beneficiary of a better relationship with President-elect Trump and was helped by higher oil and commodity prices. Other countries benefitting from higher commodity prices and a lower currency included Argentina's Merval (+45%), Brazil's Bovespa (+39%), Norway's All-Share index (+18%) and Canada's TSX Composite (+17.5%). Losing markets included places with political questions or economic "indigestion": Poor prospects for European banks led the pan-European Stoxx 500 index to close with a -1.2% loss for the year. Italy's MIB index was down -10.2% for the year due to its constitutional crisis and problem banking system. China's market was down as much as 30% at one point due to unrest in the property markets and a weakening yuan due to capital flight; the Shanghai Composite managed to recover some of the losses to end the year with a -12.3% loss.

Bonds

Long-term bonds worldwide saw rising rates during the quarter, led by 10-year US Treasury rates which peaked at 2.60% in mid-December after starting the quarter at 1.62%. More surprising was the rise in the long-term bonds of Europe and Asia which don't have the growth prospects or the budding inflation seen in the US: German 10-year rates rose from -0.10% (yes – investors were paid to hold these bonds on September 30th) to 0.39% in mid-December, while UK 10-year bonds rose from 0.75% (on 9/30/16) to 1.50% in December. Japanese 10-year bonds, part of the Japanese QE program in which 10-year rates are to be pegged at 0.00%, rose from -0.075% at the end of the 3rd quarter to as high as 0.09% on 12/15/16, before settling at the end of the year at 0.059% (notably above the 0.00% target rate).

Closing the year at 2.446%, the US 10-year Treasury ended up returning -0.02% (including interest) as the late rise in interest rates wiped out all the capital gains and interest for the year; the move is especially noteworthy because the low yield was 1.37% in mid-July, matching a 230-year low reached in 2013. We sold our Treasury bonds in December after yields refused to stop at key technical levels, keeping a small gain for the year. We were surprised yields moved up in almost a straight line all fall, a severe move almost never seen in large, liquid markets absent a more catalyzing event.

Currencies

Currency moves were big market drivers, both during the quarter and for the year as a whole. The star of the fourth quarter was the US dollar, which rose almost constantly all quarter after being lower for the first three quarters of 2016; the US Dollar Index rose approximately +7.2% during the fourth quarter, ending the year +3.6% higher. The resolution of the uncertainty caused by US elections started the dollar higher, and Trump/Republicans victory powered it higher in November and December.

Virtually all currencies were lower versus the dollar, although some losers were more notable: the Mexican peso was the largest loser, falling -17.0% for the year (-13.4% since the election) as Trump's protectionist campaign promises threatened Mexican economic growth and future prospects. The British pound ended the year down -16.2% with the risks of a difficult Brexit process facing the UK and EU. The euro, the largest component in the US Dollar Index, ended the year at 1.052, down -3.1%, having fallen -5.9% since the US elections. The Japanese yen, the other large component of the US Dollar Index, was higher for the year by +2.8%, closing at 117/dollar after rebounding from its extreme weakness in 2014-15.

Energy

The energy markets were the big winners for 2016 although oil was relatively range-bound during the fourth quarter compared to the rest of the year. The surprise OPEC/non-OPEC production-limiting

agreement of September was finalized during the quarter, offsetting the typical late fall price swoon, keeping crude oil in the $50s. WTI closed at $53.72, a gain of approximately +3.1% for the quarter and +45.0% for the year. Gasoline was up +31.5% for the year, helping push up inflationary forces in the US economy. Natural gas was the big winner in the financial markets, coming off a 17-year low in February; natgas gained the rest of the year due to supply restraints (from low prices and energy producer financial distress) and increased usage (hot summer), gaining +57.6% for the year, ending at $3.724/MMBtu.

Precious Metals

Both gold and silver had poor fourth quarters as slight upticks in both the US and Euro economies, removal of uncertainty of the US election results and the Fed raising interest rates in December led to sell-offs in the precious metals and metals mining companies. The miners did rebound during December, gaining +1%. Interestingly, base metal mining companies (with poorer prospects due to a slowing Chinese economy) outperformed precious metals miners during the fourth quarter as traders embraced risk and the subsequent price momentum, even though fundamentals favor the precious metals. Gold ended the quarter at $1150/oz, down -12.4% but was a winner for the year, rising +8.6%. Silver outperformed gold; while it lost -15.7% to end the fourth quarter at $15.989/oz, silver rose +15.8% for the year. The precious metals miners, as represented by the Van Eck Vectors Gold Miners ETF (GDX) fell -18.0% for the quarter <u>but still gained +52.5% for the year</u>.

Going Forward

Now that the US has a businessman in the Oval Office, supported by a majority in Congress and with a more pronounced mandate for change than any administration in decades (due to his election after distinctly different campaign rhetoric than most), we anticipate substantive changes in taxes, regulation and the entrenched Washington mentality, giving companies the ability to grow their revenue and profits. This could help both the economy and the markets. However, there are still some impediments to growth: governmental and corporate debt, a mismatch of skills needed and those possessed by the labor force, and the strong US dollar. We will examine these elements in more detail below.

Equities

One major narrative that most market participants are monitoring is the historical performance of equities in the wake of US Presidential elections, or more specifically, the markets' behavior after a new President from the opposite party is elected after an incumbent has completed two terms. Typically, the market rallies in the wake of a change in administration as hope for positive changes initially reigns; this is usually followed by a January correction as some doubt creeps in, followed by a subsequent rally as the new President starts presiding, followed by a substantial correction (10-20%) during the spring when many hoped-for policies or at least campaign promises fail to become law

immediately – either moving more slowly than market participants expected or failing. We believe the dynamics that typically drive this cycle exist with Trump's ascendance to the Presidency, especially with valuations being historically high – according to data provider Factset, the S&P 500 is trading at 17x 2017 forecast earnings versus a ten-year average of 14.4x (over 18% above the average). Thus, we expect gains in early 2017 with a spring/summer drawdown, followed by a recovery.

Offsetting this historical tendency are a couple of major factors that could overpower the expected correction: 1) the technical setup of the market and 2) the allure of new US investments. The technical setup of the market is interpreted by many to be very bullish. In a chart of the S&P 500 [the 500 largest US public corporations], the line drawn through the 2090 level was first achieved in late 2014, and the market has corrected down from it twice (August 2015 and January 2016) but advanced back to it each time. The S&P 500 then broke out to a new high in mid-2016, but corrected, stopping again around the 2090 level. Then, the S&P broke out to a new "higher high" after the Trump/Republican election victory in November, and has gone sideways since mid-December. The technicals now indicate that this 2260-70 level in the S&P 500 could be a consolidation of the new uptrend, which serves the same purpose as a correction. The new uptrend, which has extended from 2083 to the 2282 high, could be paused in a "midpoint consolidation," thus indicating that the uptrend's second "half" should extend the same amount (roughly 200 points) to achieve a new 2017 high of 2480 or so.

In addition to the technicals, the attractiveness of the US markets and business prospects is attracting foreign capital, which serves as fuel for higher highs in equities. With the US exhibiting close to 3% real GDP and the Fed raising interest rates, the US dollar has been going higher as foreign capital moves to US investments for growth and income. While many major world economies have shown a recent uptick in growth, none has shown the upward trending growth rate of the US economy; the hope of Trump's reforms (lower taxes, less regulation and infrastructure rebuilding) only add to the

attractiveness of US markets to foreigners, which could help push up the stock market, especially with the abovementioned technical setup.

Thus, we are bullish about the direction for US equities, but we may need to get through mid-2017 "correction zone" before we think US stock markets can rally in the 2nd half of 2017. However, longer term, extremely high stock market valuations and the historically high level of debt, both in the US and worldwide, gives us ongoing concern. Current forces in the market and to a lesser extent in the economy don't seem to indicate a recession in 2017. Also, flows of funds point toward gains in US stock markets this year.

Currencies

A big determinant of value going forward will be the positioning of the US Dollar. As related above, the dollar has benefitted from the relative attractiveness of investment prospects in the US, and capital has moved to US investments (highlighted by capital flight out of China). In addition, the Fed has begun its rate-rise cycle, in direct contrast to easing in the Eurozone and Asia. Both these forces have pushed up the dollar to highs not seen in many years. We do have to remember that "too strong" a dollar starts to impact corporate profitability (as 40-45% of S&P 500 sales are international), and with the dollar at multi-year highs, its high valuation is a concern for US exporters. Thus, we think the Trump Administration may try to temper dollar exuberance to keep the dollar from rising too quickly; in fact, Secretary of the Treasury designate Steve Mnuchin said in his confirmation hearings that he thought the current dollar strength was "excessive". Many in the market see dollar strength as overdone in the short-term, as evidenced by CFTC futures market data that shows Commercial traders' net dollar position at the shortest they have been in months (betting on a dollar drop short-term).

However, we look for medium-to-long-term trends, and we believe foreign capital flows to the US will continue as Trump's policies help growth build in the US economy, causing higher interest rates as growth causes inflationary pressures. We also see the peso dropping, as growth prospects fall somewhat and inflation builds. Thus, we will continue to hold our long dollar/short euro and short yen ETFs in our portfolios to take advantage of dollar strength enhanced by US growth prospects, interest rate differentials and looser monetary policy overseas.

Economy

The economy has improved slightly this fall as uncertainties were cleared up (elections), companies spent their remaining budgets and government spending ramped up in front of November elections. However, we are concerned that the stock market euphoria over a Trump/Republican government that cuts taxes, regulations and impediments to growth is "too much, too soon" because legislation, implementation and the results of these appearing in the economy will take months and maybe into next year to impact results. In addition, Trump's election didn't impact the huge amount of

government debt outstanding (and corporate debt, for that matter), which is a drag on growth, especially if interest rates rise, diverting more cash flow to debt service.

Thus, we see the economy continuing its slow growth, enhanced at times by falling structural impediments to growth (tax cuts, announcements of public and private spending programs) but not achieving the higher growth imagined by the incoming administration officials until later in 2017. We do think that increasing economic activity and the optimism shown by the public and corporate officials (confidence polls are at multi-year highs post-election) will lead to building inflation, as foreign money and increased infrastructure spending strains supplies of all kinds of industrial products, and to a lesser extent, base metal supplies.

Bonds / Interest Rates

With our view that the economy will increase its growth, albeit slowly (as referenced in the Economy section), we see bonds bouncing between lower yields (as economic statistics disappoint) and higher yields (better stats, higher inflation readings and climbing equities). Having said that, we see a number of inflationary elements that continue to impact bonds, and, we believe they will keep rates around these levels or higher over the next couple of years. First, CPI costs affecting most Americans are showing upward pressure: rent/shelter costs continue to climb due to lower supply and higher costs associated with new construction apartment projects nationwide. Energy prices have reset from crude in the $20s/bbl and gasoline under $2.00/gal to a crude in the $40s-50s/bbl and gasoline over $2.50/gal. Healthcare costs have continued to climb (although that could change in the future), and private education costs continue to climb.

In addition, we see the Fed keeping its rate hike plan going, although the amount of rises may not happen as quickly as the Fed currently projects (four in 2017, while many forecasters see three max). Interestingly, European and Japanese long-term interest rates, which were negative for much of 2016, have turned positive as US rates rise and an improving US economy pushes up longer-term US Treasuries, which “pull” up longer-term bonds around the world (as worldwide bond investors sell lower yielding bonds and move to higher yielders). We believe long-term rates will end the year higher, but will probably have a spike lower when equity markets correct, which we expect to happen sometime mid-year. Large banks and commercial traders are currently long Treasuries, expecting a “snap back” rally in prices (and lower yields) – not only from an equity correction but also from disappointment if Trump’s tax and infrastructure programs are not passed quickly. However, if tax packages pass easily into law, rates could move up quite more quickly. Despite this possibility for gains in bonds, we will stay at low levels of bond ownership because we think the move could be short-lived, and we see inflation continuing to build, which will hurt bond prospects.

Energy

The energy markets continue to be a study of hope and momentum. The fundamentals and past history point to higher supplies and thus lower prices going forward. The production ceiling put into place in late 2016 by OPEC and non-OPEC producers has had the compliance that skeptics like us expected: it was estimated by OPEC members themselves that adherence is only by 80-85% of its members (and Libya and Nigeria don't have limitations due to their producing far below peak production levels). In addition, Russian production does not seem to have fallen at all (Rosneft, the partially government-owned Russian oil company, has published rising production estimates in 2017) and, of course, US shale production is rising due to increased drilling caused by higher prices.

All of this would point toward a price decline, but we have not seen a price below $50/bbl since early December. We are skeptical prices can stay this high due to the reasons cited above. We are not alone: the large commercial companies tracked by the CFTC are currently short the largest number of crude oil contracts in many years, at or near the level when oil was last over $100/bbl (summer 2014). Therefore, we believe crude oil will correct in price in the near future as supply overwhelms demand in the short-term. The spring will bring the building of gasoline inventories for the summer driving season, so refiners may be on our radar screen for new investments. For now, we will stay with our pipeline/MLP positions and our supermajor investments since they are less affected by price movements.

The strength in natural gas was likely due to a mismatch of deliverability with peak natgas needs on very cold days in the Eastern US during December. As the cold has moderated, the price has dropped quite a lot. We see natural gas reserves as being more than plentiful, and drilling techniques continue to be more productive, meaning domestic natural gas supplies will be plentiful, and prices will moderate to reflect the situation.

Precious Metals

With the bullish forces explained above in the Equities section, we see a lot of capital moving to attractive assets in the US, leading to a strong US dollar. A strong dollar is the other side of weaker worldwide currencies, especially those of regions actively providing monetary stimulus: China, Japan and the Eurozone. The inflationary effects of higher energy and shelter prices, coupled with falling currencies in many parts of the world, is causing inflation to rise and is driving worldwide investors to protect their capital –one time-tested way is investments in precious metals.

Thus, in spite of a still-strong dollar, precious metals have been rising since mid-December as capital looks for relative stability and for preservation of purchasing power. In addition, we think markets have absorbed the Fed's rate rise program of three hikes in 2017; if the Fed moderates its view (as it did last January/February), precious metals will be big beneficiaries. Also, if the dollar corrects from its highs, metals will benefit. Lastly, if equity markets correct, precious metals investments have

proven to offset equity market losses. We see all of these factors as possible (if not probable), leading us to maintain an overweight in metals and mining company equities.

Kanos Quarterly Commentary

The Difficulty of Thoughtful Investing Today

When dealing with investments, people often ask experts "what are you buying now" and "what is the hot stock". One origin of this thinking is how stockbrokers used to be paid: commissions for trading. They would call customers with "hot tips" to try to get customers to buy the new thing (and many times sell an existing position to finance it). This generated two commissions for the stockbroker, and may or may not have been for good reason. Today, many people in the markets are looking for what has momentum, trying to put money into things that are "going up", not necessarily thinking about the fundamentals of the company or what is propelling the stock higher. A number of traders use technical analysis, believing the past movements of prices will give a "leg up" on predicting future movements, and use chart-reading techniques to formulate their trading positions.

At Kanos, we do a lot of research on macroeconomic and monetary activities, homing in on attractive sectors and, with more research, attractive stocks. We construct a diverse portfolio of attractive investments that we hope will build wealth over months and years. We often use trading techniques to formulate a more favorable time to establish a position (or hold off until conditions change). In addition, with the relatively high volatility of markets around the world (including equities, bonds, currencies, commodities and even volatility itself), we trade a smaller part of the portfolio, taking starter positions in potential investments or buying to follow the anticipated move in an index, sector or stock, all while keeping a close eye on these positions to try to make a shorter-term profit. We consider these two approaches separately: the first is investing while the second is trading.

Investing versus Trading

We consider investing to be the way we will build your wealth over time; it is our forte. We consider trading a way to take advantage of attractive opportunities that we are not confident will continue into the medium-term; they are short-term plays that will either move the way we anticipate or we will sell them. We spend the majority of our time on the former, but with so much volatility lately, we also have expanded our trading.

So, what are some of the noteworthy differences between investing and trading? Here are some of the ones that we think are important.

1) **Give It Time** – In investing, especially value investing, you are trying to buy something that you hope the market will recognize to be more valuable in the future. If you have done your research well, you should be correct but it may take some time for the market to agree with your point of view. Thus,

you sometimes have to stay with a losing position (but continue to update your research to make sure the market doesn't see something you didn't initially) until the market turns around.

In trading, if the stock doesn't start to move your way, you want to sell it relatively quickly because it did not move as anticipated (the reason for the trade) and you may not have done as much research on the idea to be a long-term holder.

2) **Let Your Winners Run** – In investing, when you have done your research and invested in a position, as the market agrees with your analysis and buyers push up the price, you start making money. When updating your research, if your bullish thesis is intact, you stay with the position, believing market participants will continue to push it higher over time as a successful business prospers. If when doing your ongoing investigation of the company and sector fundamentals, you see business prospects losing their attractiveness, you will consider selling. Losing positions should be analyzed frequently to monitor their fundamentals and your investment thesis. If the thesis isn't recognized by the market or conditions prove less favorable, you sell the losing position. Thus, with investing – let your winners run and sell your losers.

   In trading, short-term movements make a bigger impact on decision making. When prices stop moving as they did previously, news emerges that may impact your trade or when the price reaches what a chart pattern has predicted, traders usually sell the position. Traders are looking to make money and move on to more attractive opportunities, so typically, traders sell their winners, looking for other more attractive situations to trade. Losers are usually sold with limited losses, as noted above in 1).

3) **Risk Management** – In investing, risk management is often performed using a series of techniques. By definition, investments are longer-term positions that are less frequently sold, so when losses in a portfolio are sustained, risk is mitigated in the following ways: a) diversification – the portfolio should have a number of investments that perform differently than each other in different market conditions, so when losses are sustained, re-weighting the portfolio with investments that will do better in current market conditions is one possibility for limiting future losses; b) hedging – the investment manager may sell a similar position short (which has poorer attractiveness) to try to offset positions currently losing value, or may establish a sector position that moves opposite the losing investment to mitigate future losses; or c) when one position/sector is causing losses (even after checking the attractiveness of the investment), the investment manager may sell a portion of the position, acknowledging that market participants have a strong opposite opinion of the position.

   In trading, risk management is much more straightforward. The trader (or risk manager or trader's manager, in an institution) has a limited amount of losses a position or portfolio will be allowed to sustain. When the position or portfolio hits that loss limit, then the position must be sold (or a number or all of the positions in the portfolio must be sold). While it sounds easy, the difficulty of risk management is that the trader has put on the trade because he thinks it is attractive and has seen short-term losers turn into winners. It is difficult to cut attractive investments just because they have encountered some losses.

So, what do these have to do with today's markets? A number of today's markets have moved for months now in ways that are not usually sustainable, especially for a large amount of time. We will highlight some examples, detailing how they are trading now versus how they typically trade, and how we are exposed to these situations. Our goal is maintaining attractive positions while protecting against a possible reversion to typical market behavior.

US Dollar and US Stocks Moving Concurrently

This situation is the most obvious anomaly. The election of Donald Trump as US President, along with a Republican majority in Congress, continues to support a stronger dollar due to the thought that anticipated tax cuts, anticipated cutting of government regulations on business and the implementation of a large program of US government stimulus makes US investments more attractive. Add in large geopolitical/economic questions from around the world: Europe (barely growing and political turmoil spreading to more countries), Japan (series of recessions and slow growth with government policy unable to reignite economy for decades), China (slowing economic growth and increasingly volatile financial markets showing possible instability), Latin America (little economic growth, rising inflation, rising political instability), and the Middle East (Syrian and Yemeni conflicts ongoing, political instability growing across the region), and you can see why the US is a magnet for capital. Finally, both short-term interest rates and longer-term interest rates have risen in the second half of 2016 and are widely expected to keep rising – this should continue to help the dollar versus the euro, yen and Chinese renminbi, all of which are being weakened by central bank stimulus while US interest rates are being raised.

However, the companies of the S&P 500 derive approximately 40-45% of their profits from overseas, so profits at many US companies could be hurt by the recent sustained strength in the dollar. In addition, President Trump's penchant for tweeting criticisms of companies for their perceived mispricing of government, healthcare or other services and the re-onshoring of US industry has started an atmosphere of negative apprehension for companies (and thus investors). This has proven to be negative for defense, healthcare and automobile stocks so far, but could be expanded as Trump sees success from these surprise attacks. Interest rates have risen and are widely expected to rise further; companies have borrowed large amounts of money in recent years to take advantage of historically low interest rates, but rate rises, which started during the fall, will start to further affect US corporate profitability. Lastly, US stocks are at the second or third highest valuation in the last 100+ years. So, we think stocks are probably more vulnerable than the dollar, but the bid in stock prices has been very strong post-election, so this correlation could be maintained for a longer time than many in the markets think.

<u>**Potential Actions:**</u>
Investing: Since we believe the dollar will fluctuate but eventually head higher, we contemplate the following strategy: buy more US domestically-oriented stocks (with less foreign earnings); underweight American multi-nationals
Trading: To be determined, as conditions dictate

US Stocks and Oil Moving Concurrently

For large spans of 2016, US stocks and oil prices have moved concurrently. Oil is a building block for energy products used by corporations, so higher oil prices should have a detrimental effect on US economic growth in general and corporate profitability specifically. While higher energy prices are good for US energy stocks, they make up less than 8% of US stock market capitalization, so more companies will be negatively affected by higher energy prices than helped. One theory, that higher oil prices is a marker for stronger economic activity, is not corroborated by economic statistics. Another explanation could be that higher current oil prices and increasing production will help produce lower prices in the future, but we believe this explanation to be too much of a stretch to be credible.

Potential Actions:
Investing: Since we are skeptical of oil and natgas price sustainability, our current strategy will be: Underweight US energy producers; overweight pipelines and domestic beneficiaries of higher production (and possibly some stronger oil services companies at lower prices)
Trading: To be determined, as conditions dictate

Financial Stocks Rising in an Environment of Rising Inflation and an Unsupportive Yield Curve

Financials rallied strongly during November 2016 with investors believing that a Trump/Republican Congress combination will lead to reduced banking regulation, higher economic activity and, thus, higher profits for financial institutions, especially money center megabanks. While anticipated reforms and economic growth will or will not happen in the future, what has emerged are two current trends: rising inflation and an unsupportive yield curve. Rising inflation hurts banking companies in a number of ways: their fixed income portfolios suffer a loss of purchasing power, their compensation costs (a large component of financial institutions' costs) rise and longer-term, their business suffers as economic growth tends to falter over time. In addition, most believe that expected economic growth will lead to rising long-term interest rates, which will cause the yield curve to steepen, allowing Financials to make more money on lending. However, two facts get in the way of this view: 1) the compaction of banks' net interest margins (NIM – the typical description of banks' lending margins) in recent years has meant that banks have made fewer loans than in past economic expansions (limiting their ability to profit from NIM expansion), and 2) the yield curve, while steepening just after Election Day, has actually **flattened** since mid-November, meaning banks' NIM should suffer rather than benefit from rising profit expectations; a diagram from a 1/13/17 ZeroHedge article "Dow 20k Disappoints…" shows how Bank Stocks have benefitted while the 2-year/30-year Treasury bond spread has flattened.

In addition, Secretary of the Treasury designate Mnuchin has said in his confirmation hearings testimony that he supports keeping the Volcker Rule, severely limiting banks' ability to trade proprietarily; we believe this further hampers the ability for banks to achieve sky-high expectations for future profits.

Potential Actions:
Investing: Due to our skepticism that financial companies will be able to grow their earnings at the rate projected without all the business they had pre-2008, we will continue to underweight financials because we think they will underperform the stock market over the next year
Trading: To be determined, as conditions dictate

VIX Near Lows with Heightened Economic and Political Uncertainty

The VIX is a volatility measure using the implied volatility assumed by equity options traders which many people involved in the stock market use as a measure for overall stock volatility. When stocks drop and uncertainty rises, the VIX rises, sometimes exponentially. The VIX's multi-year average is in the 18-19 range. For scale, a VIX reading of 30 indicates higher volatility usually seen after a drop in equity markets and a 100 reading is the type of extreme reached in 2008/9 after markets crashed. Today, the VIX is under 11 indicating extreme calm, which is not unexpected with US stock markets at all-time highs and trading in a relatively tight range. However, extremely low VIX readings show such extreme calmness that the next market move is many times negative, which would raise the VIX as options traders price in higher premiums. We believe the market setup could cause the VIX to rise: the unexpected victory of Trump, his January barrage of executive orders and the start of implementation of some of his more controversial initiatives (building the Mexican wall, introducing the concept of border taxes, provoking Mexico and China with straight talk, etc.) have left a large number of people and the political establishment off balance. As Mark Cudmore, a former FX trader now with Bloomberg writes on 1/26/2017 (in "A Self-Described Permabull is Worried"): "Equity investors seem to be in denial of the threat to the global economy from Trump's proposed protectionist policies, and instead solely concentrated on stimulus we're not seeing yet." One would expect the VIX to be rising as China starts to "saber rattle" and Trump falls into a war of words with Mexican President Pena. Instead, the "non-bearish" price action of US equity markets continues as tax proposals and infrastructure programs are being debated in Congress.

Potential Actions:

Investing: The complacency signaled by a very low VIX reading often is a precursor to some stock market volatility, so we will limit our exposures to high beta and high valuation stocks, while keeping on our portfolio components that provide stability like utilities, staples and even precious metals

Trading: To be determined, as conditions dictate

Bonds, Gold and Consumer Stocks Moving Concurrently

Bonds are generally influenced by changing interest rate expectations, monetary policy, economic growth expectations and inflation. As inflation rises, bonds are negatively affected – yields rise (to compensate for higher inflation) and bond prices fall. Gold prices are affected by inflation, perceived uncertainty and monetary policy. As inflation rises, gold is usually bolstered. Consumer Staples stocks usually pay attractive dividends and are considered to be least affected by economic cycles, thus leading to their usually high relative valuations. As inflation rises, these companies are considered masters at passing through costs to consumers, so they generally don't suffer as much as more cyclical companies when rising inflation hurts economic growth.

Bonds, gold and consumer stocks usually move in very different ways; bonds and gold are usually inversely correlated, consumer stocks and gold are affected in similar ways by many economic factors, but consumer stocks generally act like stocks, and gold is less correlated with stocks.

Lately, however, all three listed categories have been moving in virtual lockstep. Most attribute this to the re-emergence of risk taking, meaning investors are shunning the relative "safety" of bonds, gold and steady-eddy Consumer Staples. Others see a rotation from these three categories, all of which were winners in the first half of 2016, to first-half underperformers technology, financial and industrial companies. However, if the US economy is going to boom (as projected by the November-December outperformance of technology, financials and industrials), inflation should accelerate and gold and consumer staples should benefit. So, this strange linkage shouldn't last, but it did for much of the second half of 2016.

Potential Actions:

Investing: As we have stated above in the rest of the letter, we think there are many reasons bonds could fall. We are still bullish on precious metals and consumer staples to provide defensiveness during corrections.

Trading: To be determined, as conditions dictate

Industrial Commodities Are Rising While the Chinese Renminbi Is Falling

Finally, while there have been sporadic bursts of good economic news out of China, most of the Chinese economic buzz we hear revolves around concerns about the Chinese banking system, the government's various plans to re-stimulate a stubbornly sluggish economy and the imposition of

various forms of capital controls to stem an exodus of capital. With these factors in mind, one would think that industrial commodities (copper, zinc, iron ore, nickel, etc.) would be dropping in price, since China is estimated to import 40% of industrial metals mined worldwide. However, prices of industrial metals have risen since early last year, defying the headline Chinese economic malaise. In addition, we see base metals companies' stock prices thriving.

Investing: Monitor company results and base metal prices to see where they are filling demand. Continue to invest in infrastructure companies that will benefit from the expected US resurgence in spending while possibly adding commodity producers in industries/sectors that show continued growth despite Chinese slowing demand
Trading: To be determined, as conditions dictate

Conclusion

While these kinds of anomalies occur frequently in markets, it is unusual to have all of these conditions happening at once. Most of these involve capital continuing to move into stocks post-election, while sovereign bonds (US Treasuries, German bunds, Japanese Government Bonds) have been sold incessantly since October. This continued capital flow into equities is the most notable aspect, as it has been stronger than most bull moves in recent years, considering the economic and political backdrop in which it is happening. We have continued to be surprised at the continued strength over time and have had to give the continuation of these flows serious consideration until events prove otherwise.

Thus, we will err on the side of caution but will continue to invest in equity situations in which we see value and think the sector has growth possibilities in the current economic environment. We will also be trading some positions to see if some of the aforementioned anomalous situations will correct back to more conventional relationships among asset classes.

The Managers of Kanos Capital Management
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